Supreme Court, U.S.
FILED
041370 FEB 3 - 2005
OFFICE OF THE CLERK

No.

IN THE

Supreme Court of the United States

JERRY S. PAYNE,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For Writ of Certiorari To
The United States Court of Appeals For
The Fifth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Congress enacted IRC, §§ 6103 and 7431 to prevent unnecessary harm from disclosures that a taxpayer is under criminal investigation. Petitioner's argument in this appeal relies on Treasury Regulation 301.6103(k)(6)-1(a), which mandates a "Level One' evaluation, as a condition precedent to an IRS police officer's grant of authority to disclose the taxpayer's name. This case is "of the first impression" regarding the application of the treasury regulations when an IRS officer fails to undertake the required "Level One" evaluation. The first appeal of this case affirmed that a "Level One" evaluation is required. After the first appeal, Respondent promulgated amended treasury regulations which negated the earlier ruling by (1) eliminating the "Level One" requirement and (2) adopting the conclusions of the dissenting opinion.[1] Respondent then argued in this appeal that the amended regulation represents Congress' intent in IRC §§ 6103 and 7431.

Although the opinion below does not declare which treasury regulation was applied as a basis for the ruling, the State of the Law indicates that the amended treasury

[1] Motivated by the War on Terrorism, the amended regulation was promulgated surreptitiously in violation of the rule of law.

regulation was applied; therefore the Questions Presented are:

1. The validity of the amended treasury regulation?

2. The retroactive applicability of the amended treasury regulation in determining congressional intent?

3. Does an IRS police officer who violates Treasury Regulation 301.6103(k)(6)-1(a), by disclosing the taxpayer's name prior to performing the condition precedent to his grant of authority to disclose the taxpayer's name, qualify for the "good faith but erroneous interpretation" exception in IRC § 7431 (b)(1), as a matter of law?

LIST OF PARTIES

The parties are listed on the caption in this case. The parties are Jerry S. Payne and the United States of America.

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PETITION FOR WRIT OF CERTIORARI

PETITIONER, JERRY S. PAYNE, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit, entered in the above-entitled proceeding on September 8, 2004.

OPINIONS BELOW

United States District Court, Southern District of Texas

The opinion in *Payne v. USA*, 91 F.Supp.2d 1014 (S.D. Tex. 1999). (Said opinion is reprinted as Appendix E.)

The opinion in *Payne v. USA*, 290 F. Supp 2d 742 (S.D. Tex., 2003) (Said opinion is reprinted as Appendix B.)

Fifth Circuit

The opinion in *Payne v. USA*, 289 F.3d 377 (5th Cir. 2002). (Said opinion is reprinted as Appendix D.)

The opinion in *Payne v. U.S.A.*, entered on September 8, 2004. (Said opinion is reprinted as Appendix A.)

Denial of motion for re-hearing entered on November 5, 2004. (Said denial is reprinted as Appendix C.)

JURISDICTION

Jurisdiction to review the judgment in question by writ of certiorari is conferred on this Court by 28 U.S.C. § 1254(1). The opinion below was entered by the court of appeals on September 8, 2004; the denial of Petitioner's motion for rehearing was entered on November 5, 2004.

The events included in the STATEMENT OF THE CASE demonstrate that the promulgation of the amended treasury regulation was injected into this case by Respondent. A review of the State of the Law indicates that the court of appeals applied the amended treasury regulation retroactively in its interpretation of the IRC. The determination of the QUESTIONS PRESENTED are necessary to resolve this controversy and therefore are within the discretionary jurisdiction of this Court; these questions present purely legal issues.

CONSTITUTION, STATUTES AND TREASURY REGULATIONS INVOLVED

United States Constitution, Fifth Amendment (Appendix M)

The Internal Revenue Code §§ 6103 and 7431 (Appendix H)

Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001: "Patriot Act"

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STATEMENT OF THE CASE

I. JURISDICTIONAL FACTS RELEVANT TO THE PROMULGATION OF THE AMENDED TREASURY REGULATION[1]

[1] Due to the unusual circumstances of this case, Petitioner has included in the JURISDICTIONAL FACTS RELEVANT TO THE PROMULGATION OF THE AMENDED TREASURY REGULATIONS the following: (a) background events surrounding Respondent's promulgation of the amended treasury regulation (b) the legal requirements when promulgating amended treasury regulations (c) summaries of the clear meaning of the previous regulations and the amended regulations (d) respondent's surreptitious promulgation of the amended treasury regulations (e) respondent's leveraging of the War on

(a) BACKGROUND EVENTS SURROUNDING RESPONDENTS PROMULGATION OF THE AMENDED TREASURY REGULATIONS

Prior To September 11, 2001, the IRS, through its regulations, handbooks and training classes, implemented Congress' formula to protect taxpayers from unnecessary disclosures to third parties that a taxpayer is under criminal investigation. After September 11, 2001, the Criminal Investigation Division of the IRS shifted focus from protecting the taxpayer to coordinating police agencies to fight the War on Terrorism.

This case "of the first impression" was previously appealed (*Payne vs. USA*, 289 F.3d, 377 (5th Cir. 2002)), wherein the court affirmed that Treasury Regulation 301.6103(k)(6)-1(a) ("Level One") requires IRS police officers to evaluate whether information sought is available from the taxpayer before disclosing the taxpayer's name to third parties. The opinion raised concerns within the Attorney General's Office as to the legality of the post-September 11, 2001 "investigative conduct" used by federal police. As a response to the opinion, Respondent amended the treasury regulations in July, 2003. The amendments (a)

Terrorism and the amended treasury regulations to influence the outcome of this case (f) unusual structure of the court of appeals' opinion of September 8, 2004. Although these events occurred subsequent to the trial of this case, the issues presented by these events are purely legal issues that require determination for the resolution of this case.

negated the court of appeals majority opinion by eliminating the required "Level One" evaluation (b) adopted the arguments and conclusions of the dissenting opinion (c) emphasized the absence of restrictions on the authority of IRS police to disclose that a taxpayer is under criminal investigation and (d) expanded the types of criminal investigations on which IRS police are authorized to disclose the taxpayer's name.

Respondent's promulgation of the amended treasury regulation falsely represented that the amendments did not involve legal or policy issues arising from congressional mandates, previous treasury regulations, executive orders or the Administrative Procedures Act; that the amendments only clarified existing law. Respondent then argued, in this appeal, that the amended regulation represents Congress' intent in IRC § 6103, which was enacted in 1976. (See Appendix K, Treasury Regulation 301.6103(k)(6)-1)) and Appendix J, Excerpts of Respondent's Promulgation of the Amended Treasury Regulations.)

(b) LEGAL REQUIREMENTS WHEN PROMULGATING AMENDED TREASURY REGULATIONS

(1) RESPONDENT'S PROMULGATION OF THE AMENDED TREASURY REGULATIONS

In July of 2003, Respondent promulgated amended treasury regulations (26 CFR Part 301). In Respondent's

presentation of the amended regulations, it represented as follows:

"It has been determined that this treasury decision Is Not A Significant Regulatory Action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that 5 U.S.C. 553(b), the Administrative Procedures Act "does not apply to these regulations . . . . (Appendix J, p. J -9-.)

However, the amendments clearly represent "A Significant Regulatory Action," as defined by Executive Order 12866.

(2) EXECUTIVE ORDER 12866

EXECUTIVE ORDER 12866 defines "Significant Regulatory Action" as follows:

"Section 3(f) "Significant Regulatory Action" means any regulatory action that is likely to result in a rule that may:

Raise novel legal or policy issues arising out of legal mandates ... or the principles set forth in this Executive Order.

EXECUTIVE ORDER 12866, Section 1(b) states that its "principles" require the following:

Each Agency shall identify the problem that it intends to address, as well as assess the significance of that problem.

Each Agency shall examine whether existing regulations, (or other law) have created, or contributed to, the problem that the new regulation is intended to correct and whether those regulations (or other law) should be modified to achieve the intended goal of regulation more effectively.

In setting regulatory priorities, each agency shall consider, to the extent reasonable, the degree and nature of the risks posed by . . . activities within its jurisdiction

Each Agency shall draft its regulations to be simple and easy to understand with the goal of minimizing the potential for uncertainty and litigation arising from such uncertainty.

IN SUMMARY, if the amended treasury regulations "raise novel legal or policy issues arising out of legal mandates or the principles set forth in the Executive Order," the amendments are required to undergo a "regulatory assessment."

As demonstrated from the clear meaning, the amended regulations (a) raise novel legal and policy issues arising out of congressional mandates and prior treasury regulations and (b) were promulgated surreptitiously, in

violation of the "principles" of Executive Order 12866, by failing to disclose the objectives and effect of the amendments.

(c) SUMMARIES OF THE CLEAR MEANING OF THE PREVIOUS REGULATIONS AND THE AMENDED REGULATIONS

(1) CONGRESSIONAL PRE 9/11/2001 FORMULA TO AVOID UNNECESSARY HARM TO TAXPAYERS

The central theme of Congress' 1976 formula in IRC § 6103, as effectuated by Treasury Regulation 301.6103(k)(6)-1(a), is the creation of conditions precedent to an IRS police officer's grant of authority to disclose the identity of a taxpayer to third parties. The structure of the regulation requires an IRS police officer to make a threshold evaluation ("Level One") of the need to disclose the identity of the taxpayer to third parties. The structure of the formula is as set out in detail in Appendix H (Congressional Pre-9/11/01 Formula to Avoid Unnecessary Harm To The Taxpayer).

(2) THE IMPORTANCE AND SIGNIFICANCE OF TREASURY REGULATION 301.6103(k)(6)-1(a)

Treasury Regulation 301.6103(k)(6)-1(a) ("Level

One") contains the most critical and significant provisions for preventing unnecessary harm to a taxpayer from an IRS police officer's disclosure that the taxpayer is under criminal investigation. A pragmatic analysis of the IRC, treasury regulations, and special agent handbooks, demonstrate the significance and importance of "Level One" in preventing unnecessary disclosures of a criminal investigation.

The court decisions interpreting the statutes, regulations, and handbooks, demonstrate that when an IRS police officer contacts third parties, that it is inevitable that the third party will acquire knowledge that the taxpayer is under a criminal investigation. This knowledge is acquired during an in-person interview when the IRS police officer shows his badge, states the nature of his duties, his affiliation with the "Criminal Investigation Division" of the IRS and discloses the taxpayer's name. If the third party contact is made through letters or other written communications, the third party will acquire knowledge that the taxpayer is under criminal investigation from ancillary headings, return receipt documents or other places where the term "Criminal Investigation Division" and/or "Special Agent" is disclosed in the writing.

Treasury Regulation 301.6103(k)(6)-1(a) was promulgated to effectuate Congress's intent with this

pragmatic analysis in mind. If the condition precedent in "Level One" is eliminated, Congress's intent to prevent unnecessary disclosure to third parties that the taxpayer is under a criminal investigation is negated.

(3) SUMMARY OF CHANGES IN THE AMENDED TREASURY REGULATIONS.

A major motivation for the July, 2003 amendments is to remove the condition precedent to an IRS police officer having authority to go straight to third parties. This change helps in coordinating federal police agencies in the War on Terrorism. A summary of the significant changes is as follows:

A. The elimination of Treasury Regulation 301.6103(k)(6)-1(a).

B. Expansion of the types of investigations in which the federal police are authorized to disclose a taxpayer's name to third parties. The previous regulation, (301.6103(k)(6)-1(b)(4)), authorized the disclosure of the taxpayer's name to third parties "to establish or verify misconduct or other activity proscribed by the Internal Revenue Laws." The new regulations add "OR RELATED STATUES." This change represents "Significant Regulatory Action," especially when coupled with the "Patriot Act."

C. Contrary to the previous treasury regulations, the amended regulations clearly were promulgated to increase police authority to investigate and to disclose that a taxpayer is under criminal investigation. Examples of specific provisions that represent "significant regulatory action" are set out in the Appendix I, (Example Provisions of the Amended Regulations that Demonstrate "Significant Regulatory Action.")

(d) RESPONDENT'S SURREPTITIOUS PROMULGATION OF THE AMENDED TREASURY REGULATIONS

Respondent's promulgation of the amended regulations secreted the objectives and effect of the amendments. Examples of surreptitious conduct used in promulgating the amended regulations are listed below.

A. Respondent's presentation of the amended regulations cite cases that Respondent contends created a need for clarification. However, Respondent did not list the case of *Payne v. USA*, 289 F.3d 377 (5th Cir. 2002), which led Respondent to amend its regulations. The opinion in *Payne,* a case "of the first impression," verified the existence of the "level one" condition precedent to IRS police officers' authority to disclose a taxpayer's name and ruled that the taxpayer is not excluded as a possible source to corroborate

evidence. The amended regulations negated these rulings.

B. Respondent states that the amended regulations were needed to reflect a recent legislative amendment to Section 6103(k)(6). However, the amendment to 6103(k)(6) simply added TIGTA officers to the officers authorized to disclose return information.

C. Respondent's presentation gives no reason for eliminating the "level one" evaluation; Respondent does not refer to the elimination of regulation 1(a), except for a provision in the amendments that says "REMOVED."

The manner in which the amended regulations were promulgated reveal a deliberate attempt to hide the objectives and effect of the amendments; this conduct violates the "principles" of Executive Order 12866.

(e) RESPONDENT'S LEVERAGING OF THE WAR ON TERRORISM AND THE AMENDED TREASURY REGULATIONS TO INFLUENCE THE OUTCOME OF THIS CASE

The following facts and events support the conclusions that Respondent leveraged the needs of the War on Terrorism and the amended treasury regulations to influence the outcome of this case:

The treasury regulation in effect at the time of the relevant disclosures require a "Level One" evaluation prior to contacting third parties. During the trial of this case Respondent specifically conceded the required "Level One" evaluation. (Appendix H, p. H-5, Respondent's Opening Statement To The District Court).

A review of the amended treasury regulation and the opinions in *Payne vs. USA*, 289 F.3d 377 (5th Cir. 2002), display a clear picture of their connection; the amended regulations negate the majority opinion and adopt most of the conclusions of the dissenting opinion. (Appendix D, 5th Cir. Opinion, and Appendix J, Excerpts from the Promulgation of the Amended Regulation).

Since the amended treasury regulations eliminate the requirement of a "Level One" evaluation, the outcome of this case turns on which treasury regulation is applied.

Respondent's promulgation claims that there is nothing new in the amended regulations and therefore there has never been a required "Level One" evaluation; while, at the same time, admitting that its promulgation of the amendments are prospective only.

One week after September 11, 2001, Rod Rosenstein, Principal Deputy Assistant Attorney General, was appointed by the Attorney General to supervise the criminal tax enforcement program of the IRS. On June 8, 2004, Mr. Rosenstein unexpectedly appeared and presented oral

argument on this case.

During oral argument Mr. Rosenstein vacillated between admitting and denying the existence of the required "Level One" evaluation. He avoided being tied to either position.

The following exchanges occurred between Mr. Rosenstein and the panel during oral argument:

This exchange seems to concede the requirement of a "Level One" evaluation.

> **Judge Stewart:** "The contention I have is, nonetheless, you say this is an objective standard. I don't want to quarrel with it. It seems that standard is nonetheless somehow shaped by compliance. What is the regulation? And, if the regulation requires level one, any reasonable officer, not just Batista, comply with, definitionally, not just him, but any reasonable officer would. Then help me understand how we just sort of moved past that as not in play under the facts of this case."

> **Mr. Rosenstein:** "We don't agree that the Special Agent didn't comply with that standard. . . . I don't think that is an accurate characterization of the district court's finding. They found Mr. Payne should get more of an opportunity to comply, as you point out, which I take exception. She didn't find that he failed to consider it.

She found that he considered it erroneously."

(Appendix L, p. L-6, Excerpts from Oral Argument, pages 19 and 20)

If the district court did find that Batista evaluated "Level One' but evaluated it erroneously, as Mr. Rosenstein argued, then this case is not "of the first impression." However, the affirmed findings are: "Batista made a large number of third party contacts in the course of his investigation of Payne without first determining whether the information sought was otherwise reasonably available. Batista did not consider himself under any obligation to seek necessary information from Payne." (Appendix A, p. A-2.)

This exchange seems to deny the requirement of a "Level One" evaluation.

> **Judge DeMoss:** "When the agent arrives at that conclusion, does he record, in anyway, in his reports to his supervisors that he has reached the point where he needs to contact third parties? Is that a matter that he reports to his supervisors as part of the process of saying: I am getting ready to go out and contact all the customers of this taxpayer . . . ? Does he record that in anyway?"
>
> **Mr. Rosenstein:** "The record does not contain a specific factual claim: 'At this moment I reached a conclusion to go to third parties.' We don't believe that should be required."

This exchange seems to deny the requirement of a "Level One" evaluation.

> **Judge DeMoss:** "I had the sense, . . . that the purpose of the Congress was to say that in – you should not go blabber to a customer of a taxpayer that he is under criminal investigation, unless you have demonstrated a need to get some information from that person that you couldn't get from the other. Is that a fair summary of what the statutory provisions say?"
>
> **Mr. Rosenstein**: "I don't believe so, Your Honor. Mr. Payne is making that argument. Obviously before Congress's actions, there were no restrictions on use of tax information. I believe the information was a free window for the government and their agents' to talk to spouses, friends, acquaintances. Under the current regime, you go home, you don't tell your spouse and friend who you are investigating. You keep it to yourself. You make the disclosures in official investigative status that are reasonably necessary. The Court's question, I believe the purpose of 6103 was generally to contain information from the IRS, not specifically to reign in criminal investigators. It had a more general purpose." (Appendix L, pp. L-8-9, Excerpts from Oral Argument, pages 28 and 29.)

(f) THE UNUSUAL STRUCTURE OF THE COURT OF APPEALS' OPINION OF SEPTEMBER 8, 2004

The meaning and objectives of the court of appeals' opinion of September 8, 2004 are a mystery. The opinion first sets out affirmed findings that Special Agent Batista violated Treasury Regulation 301.6103(k)(6)-1(a); that Batista's failure to perform the "Level One" evaluation was due to Batista's intentional conduct and/or gross negligence in making third party contacts without performing the "Level One" evaluation. The opinion then affirms that under these findings Batista is entitled to protection from the "good faith but erroneous interpretation" exception in IRC 7431(b)(1), as a matter of law.

Since the State of the Law dictates that an unauthorized disclosure in violation of a treasury regulation disqualifies an officer from protection under the "good faith" exception, the conclusion that the court of appeals applied the amended treasury regulation seems inescapable.

If the court of appeals evaluated and concluded that the need for adjustments of police powers to fight the War on Terrorism is more important than Petitioner's recovery in this case, its conclusion is clearly correct. However, as discussed later in this petition, neither compare to the importance of the demonstration of judicial supervision over increases in police power during the War on Terrorism.

II. FINDINGS AND PROCEEDINGS IN THE LOWER COURTS

(a) DISTRICT COURT'S FINDINGS

The district court's amended findings refer to "Batista's outrageous conduct;" "that the conduct exhibited by Special Agent Batista was egregious;" that Batista did not abide by Treasury Regulation 301.6103(k)(6)-1(a); that Batista did not allow Payne to furnish the information sought; that Batista did not make an evaluation of whether the information he was seeking was available from Payne prior to disclosing Payne's name to third parties; that Batista refused to allow the taxpayer to know what information he was seeking; that Batista admitted at trial that he did not make a "level one" evaluation; that Batista admitted that he should have made such an evaluation; that Batista admitted that it was wrong for him not to make such an evaluation; that Batista knew he was supposed to make such an evaluation.

The district court's findings, which were affirmed by the court of appeals, are that Batista violated Regulation 301.6103(k)(6)-1(a) by not making the "Level One" evaluation. These findings, as summarized by the court of appeals, are as follows:

Batista made a large number of third party contacts in the course of his investigation of Payne without first determining whether the information sought was otherwise reasonably available.

Batista did not consider himself under any obligation

to seek necessary information from Payne.

Batista disclosed numerous items of return information to these third parties, including the fact that Payne was subject to a criminal investigation.

There was no evidence that any of the disclosures of return information were necessary to obtain the information Batista sought.

Batista's disclosures did not result from a "good faith but erroneous interpretation" of the applicable statutory provisions.

Batista's improper disclosures damaged Payne's law practice.

Batista grossly abused his discretion in making the numerous third party contacts without first affording Payne the opportunity to provide the needed information and in particular by inquiring about Payne's involvement with illegal drugs.

The United States' litigation position was unreasonable given that Batista made no determination as to whether the information he sought was otherwise reasonably available. (Appendix A.)

(b) THE COURSE OF PROCEEDINGS BELOW

This case is one of many proceedings since 1988 involving Payne and the I.R.S. In 1988 the I.R.S. began a secret investigation of Payne that led to Payne's filing this lawsuit in 1993. In 1995, while this lawsuit was pending, the IRS obtained a five-count indictment of Payne. All criminal charges against Payne were dismissed. The IRS' next attacks were through the tax courts. The I.R.S. initiated ten tax court proceedings, including one which was resolved in *Payne v. Commissioner of Internal Revenue*, 224 F.3d 415 (5th Cir. 2000). (The opinion is reprinted as Appendix G.) In that case the court reversed the tax court decision and rendered for Payne.

All of the above proceedings between Payne and the IRS were resolved in Payne's favor. Agency records and the testimony of its agents confirm that the proceedings against Payne were undertaken for purely private reasons, in retaliation for Payne's functioning as an attorney.

In this case, Payne sued for damages caused by Special Agent Batista's unauthorized disclosures to third parties that Payne was under a criminal investigation. The case was tried in August of 1998 before the Honorable Vanessa D. Gilmore. This case is "of the first impression" regarding the application of the IRC and treasury regulations

when an IRS officer fails to undertake the required "Level One" evaluation. In the trial, both Petitioner and Respondent argued that a "Level One" evaluation is required by Treasury Regulation 301.6103(k)(6)-1(a). The district court found that Batista did not perform the required "Level One" evaluation and entered judgment for Payne for actual damages, punitive damages, legal fees and costs.

The IRS appealed the district court's judgment. In *Payne vs. USA,* 289 F.3d 377, (5th Cir. 2002), the court affirmed that a "level one" "determination must be made in light of the 'facts and circumstances of the case' and that the taxpayer's cooperation legitimately forms part of the inquiry." The court reversed and remanded the judgment for further findings on the "good faith but erroneous interpretation" exception in its IRC, Section 7431(b)(1). The district court was to evaluate the impact of *Gandy v. U.S.,* 234 F.3d 281 (5th Cir. 2000), which was issued subsequent to the district court's ruling on this case.

On remand, the district court ordered that Payne take nothing, concluding that the ruling in Gandy required, as a matter of law, the ruling that Batista's unauthorized disclosures of Payne's name and the fact of a criminal investigation were protected by the "good faith but erroneous interpretation" exception. (Payne v. United States, 290 F.Supp.2d 742, 759 (S.D.Tex.2003)).

On September 8, 2004, the court of appeals issued an opinion affirming the amended final judgment that Payne take nothing. The opinion did not explain the court's ruling or declare which treasury regulation was applied.

Petitioner filed a motion for rehearing which was denied on November 5, 2004.

REASONS FOR GRANTING THE WRIT

I. RESPONDENT'S VIOLATION OF DUE PROCESS OF LAW

The law is clear that Respondent's violation of Executive Order 12866 and its own rules, in a manner that affects statutory or constitutional rights, is a denial of Due Process of Law guaranteed by the Fifth Amendment of the United States Constitutions. *US v. Caceres,* 440 U.S. 741 (1979); *US v. Shaughnessy,* 347 U.S. 260 (1954).

Petitioner has set out in the STATEMENT OF THE CASE – Jurisdictional Facts Relevant To The Promulgation Of The Amended Treasury Regulation – the clear facts and clear State of the Law demonstrating Respondent's usurpation of increased police power. The clarity of the demonstration of Respondent's surreptitious conduct in usurping individual protections mandated by Congress, displays the need for this Court's attention on this case.

(a) UNIQUE IMPORTANCE OF IRS
POLICE IN THE WAR ON TERRORISM

Due to circumstances not anticipated by either party to this case, this case evolved into issues of great public importance; issues that involve the usurpation of increased police powers, in violation of the basic structure of our government.

Congress granted IRS police greater and wider authority to investigate the conduct of American citizens than has ever been granted to any other police agency. The grant of virtually unlimited authority to IRS police is required because of the need to enforce our income tax laws. Congress' grant of authority allows IRS police to investigate any conduct, by any American citizen, at any time, either business conduct or personal conduct; this unlimited grant of police power has been justified by recognition that any conduct of a person might be a component of conduct that potentially might be an income producing event. The result is that IRS police are not required to have evidence that a crime has been committed to have authority to investigate any American citizen.

The only restrictions enacted by Congress to protect taxpayers from unnecessary harm from disclosures that a taxpayer is under criminal investigation is the enactment of

IRC §§ 6103 and 7431. However, as has been explained above, the Attorney General's office has surreptitiously eroded and eliminated these protections by way of its amended treasury regulations.

(b) U.S. ATTORNEY GENERAL'S USURPATION OF POLICE POWER

After September 11, 2001, it became necessary to coordinate federal police agencies to root out terrorism in this country. The broad authority given IRS police to investigate any American citizen is being used to fight the War on Terrorism. Understandably, the Attorney General's office focused on the use of the IRS police force in conjunction with the "Patriot Act" to coordinate and share investigations among federal police agencies.

The facts reveal that the Attorney General's effort to adjust police powers and individual safeguards, has not been undertaken according to the rule of law. The objectives of the Attorney General are to coordinate IRS police with other police agencies to contribute in the War on Terrorism. We may very well need to give IRS police officers additional powers or we may very well not need to do so. What we do know is that the Attorney General's surreptitious attempt to give police agencies greater powers, while claiming it is not

giving the police greater powers, is unlawful and needs supervision by The Supreme Court Of The United States.

(c) THE URGENCY OF THE NEED
FOR THE COURT'S ATTENTION

This case presents an opportunity for the Court to address issues that represent the Court's most sacred responsibility; the duty to deny the usurpation of individual rights by police agencies. It seems unlikely that these issues will be presented to the Court again anytime soon. The ability of a citizen to seek protection from Respondent's usurpation of increased police powers is, at best, well hidden. Federal statutes such as the "Anti-Injunction Act," the "Declaratory Judgment Act," and other federal statutes that provide a remedy for citizens seeking protection, all exempt abuse by IRS police. Any attempt through the court system to enjoin enforcement of the illegal amended treasury regulations, would literally take years to make its way to this Court. It is unlikely that such a case will present itself to the Supreme Court of the United States in time to prevent harm to American citizens, during the War on Terrorism.

As adjustments in police powers to fight the War on Terrorism evolve, there develops an increased need for clear, supervisory participation by this Court. There exists an urgent and important need for this Court to demonstrate

judicial supervision over adjustments of police powers and individual protections. Indeed, the American people need to feel judicial supervision over the usurpation of police powers, during the War on Terrorism.

II. THE LOWER COURT'S APPLICATION OF THE TREASURY REGULATIONS

(a) STATE OF THE LAW IN APPLYING THE "GOOD FAITH" EXCEPTION IN IRC § 7431(b)(1)

The circuits agree as to the State of the Law in the application of the "good faith" exception when an unauthorized disclosure is made in violation of a treasury regulation. All of the circuits follow the "*Huckaby* Standard" (*Huckaby vs. U.S.*, 974 F.2d 1041 (5th Cir. 1986)). In the first appeal of this case, the court explained the "*Huckaby* standard:" "a reasonable IRS agent can be expected to know statutory provisions governing disclosures, as interpreted and reflected in IRS regulations and manuals. An agent's contrary interpretation is not in good faith." (Appendix D, *Payne vs. USA* (2002).

In the amended opinion, the lower court held that, "the good faith exception operates to protect the United States from liability for all of the oral disclosures of the criminal nature of the investigation" (Record Excerpts p.21,

¶11); "that the good faith exception excuses oral disclosures of the criminal nature of the investigations, because a reasonable agent may conclude that he is authorized to orally disclose that he is conducting a criminal investigation." (Record Excerpts p. 22, ¶13); that the disclosures in writing of Payne's name and of the criminal nature of the investigation by the words "Criminal Investigation Division" on signature blocks or ancillary headings were not actionable. (Record Excerpts p. 23, ¶14.)

If Treasury Regulation 301.6103(k)(6)-1(a) is applied to this case, these holdings are not correct. Since Batista disclosed Payne's name in violation of the regulation, all of the unauthorized disclosures of Payne's name and the criminal nature of the investigation are unauthorized and not in good faith.

(b) DISTINGUISHING GANDY

Applying Treasury Regulation 301.6103(k)(6)-1(a) to the facts of this case and to the facts of *Gandy v. U.S.* 234 F.3d, 281 *(5th Cir. 2000)*, shows that the distinguishing fact between *Gandy* and this case is that in *Gandy* the agent's disclosure of the taxpayer's name was authorized, while Batista's disclosures of Payne's name were done without a "Level One" evaluation and were therefore unauthorized. (Appendix F, Opinion in *Gandy vs. U.S.).*

The *Gandy* case involved the application of Treasury Regulation 301.6103(k)(6)-1. The entire premise of the ruling in *Gandy*, was the fact that the agent was acting within his authority when he showed his badge, stated the nature of his duties and orally disclosed the taxpayer's name. In *Gandy*, the facts surrounding the in-person interview were undisputed. *Gandy* did not claim that the agent failed to undertake the required "level one" determination. The *Gandy* opinion held (a) there was no specific regulation, handbook provision, or case law stating that an agent could not state that the taxpayer was under criminal investigation during an oral interview, and (b) the agent was aware that he was allowed to show his badge, state the nature of his duties and disclose the taxpayer's name. Therefore, the *Gandy* holding was that the agent had a "good faith" belief that he could state that the taxpayer was under a criminal investigation during the in-person interview, since showing his badge, stating the nature of his duties and making the authorized disclosure of the taxpayer's name had already disclosed the criminal nature of the investigation.

In this case, unlike *Gandy*, there were no authorized disclosures of the taxpayer's name in the in-person interviews that could act a premise for the holding that Special Agent Batista had a "good faith" belief that he could disclose the fact of the criminal investigation. Contrary to

Gandy, in this case, Special Agent Batista did not perform the "level one" evaluation required to have authority to disclose the taxpayer's name.

As a matter of law, Batista's unauthorized disclosures of the taxpayer's name and the criminal investigation do not qualify for the "good faith" exception since his conduct violated Treasury Regulation 301.6103(k)(6)-1(a).

It is not within the intent of Congress that conduct such as Special Agent Batista's conduct would be excused under the "good faith but erroneous interpretation" exception. The court of appeals opinion of September 8, 2004 creates intolerable conflicts and confusion as to the conditions precedent to an IRS police officer's authority to disclose the taxpayer's name to third parties and in how the "good faith but erroneous interpretation" exception should be applied.

CONCLUSION

[Ensuring Public Confidence]

The facts clearly indicate that Respondent promulgated the amended treasury regulations in violation of the rule of law; that Respondent's surreptitious conduct in usurping individual protections mandated by Congress is a denial of due process of law guaranteed by the Fifth Amendment of the United States Constitution. During the War on Terrorism, the importance of this Court's supervision over the adjustments of police powers and individual

protection is great and urgent. This country needs the demonstration by this Court of its function in denying the usurpation of individual rights by police agencies.

This Court should declare the Amended Treasury Regulations of July 2003 void; any attempt by Respondent to function under said amended regulations should be enjoined.

If the changes in the treasury regulations are needed, Respondent should be informed that the amended regulations must be promulgated pursuant to the rule of law, which requires a "regulatory assessment" as provided by Executive Order 12866.

The findings of the lower court and the settled State of the Law concerning the application of the "good faith" exception in IRC § 7431(b)(1), dictate the clear error of the lower court's conclusion that the "good faith" exception is applicable, as a matter of law.

The treasury regulations applicable to this case require a "Level One" evaluation; Special Agent Batista did not perform the required "Level One" evaluation; under the State of the Law followed by all circuits, Batista's disclosures of Payne's name and the fact of criminal investigation is unauthorized and not excused by the "good faith" exception, as matter of law.

Respectfully submitted,

JERRY S. PAYNE

APPENDIX A

Filed Sept. 8, 2004

UNITED STATES COURT OF APPEALS
For The Fifth Circuit

No. 03-20131

JERRY S. PAYNE; et al.,
Plaintiffs,
JERRY S. PAYNE,
Plaintiff-Appellant

VERSUS

UNITED STATES OF AMERICA; et al.,
Defendants
UNITED STATES OF AMERICA,
Defendant-Appellant-Cross-Appellee

Appeal from the United States District Court
For the Southern District of Texas, Houston

(H-95-CV-1364)

Before KING, Chief Judge, and DeMoss, and

Stewart, Circuit Judges.

PER CURIAM *

Appellant Jerry Payne filed suit against the United States to recover damages for alleged unlawful disclosure of confidential tax return information by Internal Revenue Service ("IRS") Special Agent Daniel Batista during a criminal investigation. Payne v. United States, 91 F. Supp. 2d 1014 (S.D. Tex. 1999). This wrongful disclosure claim was tried to the court, and at the conclusion of the trial, the district court found that: (1) Batista made a large number of third-party contacts in the course of his investigation of Payne without first determining whether the information sought was otherwise reasonably available; (2) Batista did not consider himself under any obligation to seek necessary information from Payne; (3) Batista disclosed numerous items of return information to these third

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* Pursuant to 5TH CIR. R. 47.5, the Court has determined that this opinion should not be published and is not precedent except under the limited circumstances set forth in 5TH CIR. R. 47.5.4.

parties, including the fact that Payne was subject to a criminal investigation; (4) there was no evidence that any of the disclosures of return information were necessary to obtain the information Batista sought; (5) Batista's disclosures did not result from a good faith, but erroneous, interpretation of the applicable statutory provision; (6) Batista's improper disclosures damaged Payne's law practice; (7) Batista grossly abused his discretion in making the numerous third-party contacts without first affording Payne the opportunity to provide the needed information and in particular by inquiring about Payne's involvement with illegal drugs; and (8) the United States's litigation position was unreasonable given that Batista made no determination as to whether the information he sought was otherwise reasonably available. The district court awarded Payne $ 1,536,680 in actual damages, $ 1,000 in punitive damages, and $105,361 in attorney's fees and costs.

On appeal, another panel of this Court reversed the judgment of the district court and remanded the case for further findings in light of this

Court's decision in Gandy v. United States, 234 F.3d 281 (5th Cir. 2000), which was issued subsequent to the district court's disposition of the case. Payne v. United States, 289 F.3d 377, 385 (5th Cir. 2002). On remand, the district court, applying the teachings of Gandy, ordered that Payne take nothing, finding that although the IRS agent improperly disclosed Payne's confidential return information, no liability attached because such disclosures resulted from the agent's good faith, but erroneous, interpretation of the Internal Revenue Code. Payne v. United States, 290 F. Supp. 2d 742, 759 (S.D. Tex. 2003). Payne timely appealed.

Having carefully reviewed the entire record of this case and having fully considered the parties' respective briefing and arguments, we find no reversible error in the district court's amended findings of fact and conclusions of law. We therefore AFFIRM the amended final judgment of the district court for the reasons stated in its order.

AFFIRMED.

APPENDIX B

Entered Sept. 12, 2003

IN THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF TEXAS HOUSTON DIVISION

JERRY S. PAYNE, ET AL.

Plaintiff

versus

UNITED STATES OF AMERICA, ET AL.

Defendant

CIVIL ACTION NO. H-93-1738

AMENDED FINDINGS OF FACT AND CONCLUSIONS OF LAW

The Court, having considered the Fifth Circuit's opinion in the above case dated May 7, 2002[1] and the

[1]The Fifth Circuit instructed this Court to make particularized findings as to "precisely what information about a criminal investigation was disclosed to which parties under which circumstances." *Payne v. United States*, 289 F.3d 377, 385 (5th Cir. 2000). The Court noted that "[determining which of these disclosures were necessary and reconciliation with

parties' respective motions for further findings, hereby issues its amended findings of fact and conclusions of law.

I. Background

In this suit Plaintiff Jerry S. Payne ("Payne") alleges that the United States is liable for unauthorized disclosures of his confidential tax return information made by Internal Revenue Agents ("IRS") agents David W. Batista ("Batista"), Kenneth Frelow ("Frelow"), and Colin Levy ("Levy") in violation of Section 6103 of the Internal Revenue Code. In particular, Payne claims that Batista, Frelow, and Levy "unnecessarily and indiscreetly contacted Payne's clients, relatives and other attorneys with which Payne has done business and . . . made wrongful and unauthorized disclosures of confidential 'return information' concerning Payne." (Fifth Amended Complaint, Instrument No. 226, at 9). For this unlawful conduct, Payne seeks actual and punitive damages. The United States denies Payne's contention, arguing instead that their agents did not disclose Payne's confidential return information. In the alternative, the United States maintains that if any

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Gandy will therefore entail further fact finding by the district court." *Id.*

disclosures of Payne's return information were made by its agents, such disclosures were authorized by law, or made pursuant to a good faith, but erroneous interpretation of the law.

This case was tried on August 14, 1998. The Court entered its original Findings of Fact and Conclusions of Law on March 19, 1999. The Court's ruling was appealed to the Fifth Circuit, and on May 7, 2002, the Fifth Circuit issued its opinion remanding this case for further fact finding. Accordingly, based on the opinion of the Court of Appeals and the newly established caselaw relevant to these matters, the Court makes the following amended findings of fact and conclusions of law. Any finding of fact that is more appropriately characterized as a conclusion of law shall be so construed.

FINDINGS OF FACT

1. Payne obtained a Bachelor of Business administration from the University of Texas in Austin, Texas. Later, in 1996, Payne received his Juris Doctorate from the University of Texas School of Law. Payne became licensed to practice law in 1966. Payne first worked as a lawyer for the city attorney's office of Houston, Texas. He then went into the private practice of law in Houston, Texas. He formed a law firm and practiced law from 1974 until 1982, In 1982, Payne left the practice of law and went into the real estate development and construction business in Austin,

Texas. After the real estate market crashed, Payne returned to the practice of law in 1985. Payne formed the law firm of Payne & Associates.

2. There were four different law firms sharing the office space where Payne worked. Mr. Robert Shaddox ("Shaddox") was an attorney who worked with Payne from the spring of 1991 to 1996. Shaddox decided to work with Payne because Payne's practice appeared to be growing over the course of three or four years.

3. Payne wanted to work on larger, more complex cases and he had a good network of referrals that would allow him to secure these types of cases. For example, Senator Buster Brown was a client of Payne. Payne worked on cases that were referred to him by Senator Brown. In addition, Payne received referrals from Senator Kay Bailey Hutchison.

4. In September of 1991, Batista began his criminal investigation of Payne. Levy had already prepared an initial report and gathered preliminary information regarding the civil investigation of Payne. Levy had substantial contact with Payne. In particular, Levy made very detailed and specific requests to Payne for information regarding 2618, Inc. Batista used Levy's report and information to begin the criminal investigation of Payne.

5. On October 29, 1991, Batista made his initial

contact with Payne by arriving at Payne's law office unannounced instead of scheduling an appointment with Payne's office. Batista admitted that he was not prohibited from calling persons who are under criminal investigation in advance. Batista brought Levy and Mr. Hicks to his initial visit with Payne. Levy had been dealing with Payne since 1989.

6. At the initial visit, Batista produced a summons for 2618, Inc. records. Payne told Batista that he would provide Batista with everything that needed to know about himself, 2618, Inc., and Mr. Leo Kalantzakis, a former client of Payne and the former owner of 1628, Inc. Batista did not ask Payne for the bank records concerning his law firm or his law practice. Batista was satisfied with his initial contact with Payne.

7. From October of 1991 to July of 1992, Payne sent numerous letters to Batista asking him to clarify the issues for which Batista wanted information from Payne. Batista wrote a letter to Payne responding to his request. In that letter, Batista informed Payne that he was under investigation by the IRS, but Batista did not give Payne the specific issues for which Batista wanted documents.

8. On December 19, 1991, Batista contacted the Texas Lawyers Insurance Exchange by phone and informed Ms. Herbert about the IRS's criminal investigation of Payne. Batista wanted to know about the $ 36.00 in interest income from the Texas Lawyers

Insurance Exchange to Payne. As of this date, however, Batista still believed that Payne was sincere about providing the requested documents and records. Batista conceded that he could have gotten this information from Payne and recognized that his criminal investigation would not have been prejudiced by allowing Payne to provide this information. Batista also admitted that he violated Section 6103 of the Internal Revenue Code by first contacting the Texas Lawyers Insurance Exchange.

9. On January 16, 1992, Payne and Batista reached an agreement on how to disclose the 2618, Inc. records. Payne and Batista agreed to adhere to several guidelines. In particular, the IRS agreed to review the records on a year-to-year basis and inform Payne which records were needed for copying. Payne would then have copies of the requested items made.

10. On January 20, 1992, Payne sent Batista a letter asking him to allow Payne to respond to any specific questions that Batista may have concerning Payne's involvement with 2618, Inc. Payne also informed Batista that he was not waiving his Fifth Amendment rights and that he would not discuss any element of Batista's investigation with him until Batista had more reasonably and fairly narrowed any issues concerning Payne.

11. After scheduling appointments and in accordance with the parties' January 16, 1992 agreement, Batista and Levy came to Payne's office and began to review the 2618, Inc. records and microfilm on January 21, 1992. Batista and Levy continued their review of the 2618, Inc. records at Payne's office on January 22, 1992.

12. As of January 21, 1992, Batista was still happy with Payne's performance, cooperation, and his efforts to produce records. Batista testified that during this period Payne's conduct did not suggest that he was insincere about his willingness to assist with the investigation.

13. On March 2, 1992, Batista and Group Manager Swayzine Fields ("Fields") met with Payne at Payne's office. During this meeting, Batista requested the work papers for Payne's 1987 and 1988 personal tax returns. Payne stated that he would provide the work papers used for the preparation of his 1987 and 1988 personal tax returns during the month of March. This was the first and only documented request for Payne's personal tax records.

14. With the exception of work papers for Payne's 1987 and 1988 tax returns, Batista never asked Payne for other personal records. Payne later told Batista that he did not have any work papers for his 1987 and 1988 tax returns. Batista never asked Payne, in

writing or orally, for any additional information regarding his personal tax returns. Later, the IRS concluded that criminal prosecution of Payne for 1988 tax liability was unwarranted.

15. On March 12, 1992, Batista interviewed Mr. Jim Duffus ("Duffus"), a Revenue Officer with the IRS. Batista knew that Payne had given Duffus all of the records regarding 2618, Inc. between January of 1988 and September of 1988.

16. Throughout March of 1992, Batista sent out 10 (ten) summons to various corporations and banks seeking bank statements, canceled checks, deposit slips and deposited items, loan applications/agreements and related records concerning Payne. Those summons issued by the IRS to third-parties did not disclose the criminal nature of the investigation of Jerry Payne.

17. Batista also contacted by phone, and met in-person several additional third-parties while investigating Payne. In most of these meetings and phone conversations, Batista revealed the criminal nature of the investigation against Payne, by identifying himself as a special agent with the IRS Criminal Investigation Division and presenting his credentials which state that he is an agent in the Criminal Investigation Division. During the course of the investigation, Batista orally identified himself as an agent in the Criminal Investigation Division or

presented his credentials in person, to the following individuals: Leo Kalantzakis, Victoria Sutherland, Tim Winata, Sarah Bilbo, Brian Hughes, Robert T. Jacob, Mara Daly-Brown, Stephen F. Austin, J. Stephen Overby, Lee Joseph, Tina Diamond, and George Fountas.

18. When Batista met with Sarah Bilbo ("Bilbo"), the former bookkeeper for 2618, Inc., he and Levy presented their credentials to Bilbo. Batista asked Bilbo whether she knew if Payne was selling drugs, an inquiry that was gratuitously nasty and prejudicial, which had no basis in fact. Batista also disclosed Payne's return information to Jeff Messock ("Messock") when he mistakenly left a summons for Arnoldus M. Hoegen-Dijkhof at Messock's home. Dijkhof purchased an automobile from Payne and Batista wanted information from Dijkhof regarding the sale of the car. Then, on March 30, 1992, Batista and Ken Frelow ("Frelow") met with George Fountas ("Fountas"), a former shareholder of 2618, Inc. Batista and Frelow identified themselves as special agents with the IRS Criminal Investigation Division and presented their credentials for Fountas's inspection. Batista also disclosed Payne's return information to Terry Graz, a former client of Payne. In total, Batista made more than twenty-two (22) contacts with third-parties during the month of March 1992 alone.

19. Later, on in April 3, 1992, Batista, Levy, and

Frelow had a meeting with Virginia Sutherland ("Sutherland"), Payne's former legal secretary, regarding the IRS's criminal investigation of Payne. The agents presented their credentials to Sutherland for inspection.

20. On May 28, 1992, Payne sent Batista a letter documenting the informal agreement reached by the parties on May 21, 1992. Payne and Batista agreed to the following:

> 1. Payne would not replead in his lawsuit against the IRS as required by Judge Hoyt;
>
> 2. Payne would file his 1989 and 1990 tax returns and provide Batista with copies. This would be done by Payne prior to July 27, 1992, which was heretofore the date of the parties' hearing before Judge Hoyt;
>
> 3. Batista would put a hold on seeking information as set out in his previous summonses until such time as he receives Payne's tax returns. Upon examination of the 1989 and 1990 tax returns, Batista would give Payne information as to the areas in which Batista required more information; and

4. After Payne received Batista's request in certain areas where he needed more information, Payne would promptly comply with said reasonable request.

21. Batista contacted Jim Schindler ("Schindler"), a real estate broker and a former client of Payne. Batista identified himself as being an agent with the criminal investigation division of the IRS and that he was conducting an investigation of Payne. Batista also informed Schindler that Payne may not have paid all of his taxes. Schindler decided that he would not use Payne's legal services again because of the outstanding criminal investigation by the IRS. He became aware of the investigation as a result of Batista's contact. Schindler also declined to refer any additional clients to Payne because of the criminal investigation.

22. When contacting witnesses, by phone, or in-person, Batista introduced himself as a criminal investigator with the IRS. Batista told these witnesses that he was investigating a possible violation of criminal revenue laws by Payne.

23. After the third-party contacts made by Batista regarding the IRS's investigation of Payne, Shaddox noticed a change in the level of business activity in Payne's law office. Payne's law office no longer received the same volume of phone calls or potential new clients.

24. Shaddox became aware that Payne's clients and other third parties were being informed that Payne was under a criminal investigation. Mr. Guy Matthews, an attorney who shared office space with Payne's law firm, called Payne's office about being contacted by the IRS concerning an investigation of Payne.

25. On July 28, 1992, Batista telephoned Mr. Neal Talmadge ("Talmadge"), a client of Payne and a corporate sales executive for the Houston Arrows Hockey Team, and informed Talmadge that Payne was under investigation. Batista contacted Talmadge to confirm that Talmadge was a client of Payne. Batista also wanted to know if Talmadge would be willing to cooperate with the investigation. Batista had already gone to the Harris County courthouse to confirm that Talmadge had been represented by Payne.

26. Batista testified that he did not feel that he had any obligation to first ask Payne about his clients before contacting them. Batista insisted that the third party contact was a more reasonable and efficient way to get the information.

27. Talmadge was disturbed by the phone call from Batista. Talmadge would not have known about the criminal investigation of Payne if he had not received the phone call from the IRS or subsequently received information from Batista. Had Talmadge not known Payne before, Talmadge would have been reluctant to

do business with Payne knowing that Payne was under criminal investigation. All of the employees at Talmadge's office knew that Payne was under criminal investigation. Some of these employees inquired about Payne's legal services. Talmadge told three or four employees about Payne's law practice and that Payne was under a criminal investigation by the IRS. As a result, these employees had reservations about using Payne's legal services and did not contact Payne regarding their legal needs.

28. Batista issued several additional summonses to former law clients of Payne requesting documents regarding any legal case in which Payne served as their legal representative. Batista also sent summonses to other third-parties who transacted business with Payne or his law firm. The summonses issued by the IRS to third-parties in this case did not disclose the criminal nature of the investigation and the cover letters sent with the summonses to third-parties did not disclose the criminal nature of the investigation of Jerry Payne. Although the certified mail return receipt cards which accompanied these summonses to third-parties contained the words "Criminal Investigation Division" on the return address side of those cards, the evidence does not indicate that any third-parties learned of the criminal nature of the investigation by looking at the return receipts. Batista did however, send twelve fax cover pages which contained the words "Criminal

Investigation Division" in the sender's address, but those fax cover pages contained no other information about the nature of the investigation of Payne. Nine of these fax cover pages contained in Plaintiff's Exhibits 95, 97, 99, 100, 125, 112, 183, 172 and 221 were used by the IRS to fax copies of orders dismissing Payne's petition to quash summonses or to follow up on telephone conversations. For the parties that were faxed the order dismissing Payne's petition to quash, Payne had previously served a copy of his petition to quash the summonses on these third-parties containing language which directly disclosed to these third-parties the criminal nature of the IRS's investigation. Therefore, the use of the words, "Criminal Investigation Division" on the IRS fax cover pages did not reveal the criminal nature of the investigation to those recipients, because the recipients already knew. The fax cover pages sent by Batista as follow-up to conversations, similarly did not reveal the criminal nature of the investigation, because Batista had previously disclosed the criminal nature by identifying himself and providing his credentials in the initial conversations. The remaining three fax cover pages at issue contained in Plaintiff's exhibits 98, 101, and 102, which also included the words "Criminal Investigation Division," in the sender's address section, were transmitted to various financial institutions. There is no indication that Batista had previously made oral or written disclosures to the recipients of these three faxes. In addition, Batista contacted people

referred to Payne by Senator Brown and Senator Hutchison. For example, Batista contacted Dr. Simeon Wall in Louisiana.

29. Batista asked Connie Rema ("Rema"), Payne's former legal secretary and former client, whether she knew if Payne either used or sold drugs. Rema worked for Payne prior to 1985, before Payne owned Caligula XXI. Batista also asked other employees of Caligula XXI and other people who had business or personal relationships with Payne, such as Payne's brothers and relatives whether they knew if Payne used or sold drugs.

30. On August 26, 1992, Payne sent Batista a letter explaining his frustration with Batista's failure to adhere to their May 21, 1992 agreement. Several of Payne's clients told Payne that they had been contacted by Batista. Bankers, referral lawyers, and individuals from Senator Brown's office informed Payne that Batista told them that Payne was under criminal investigation. Payne informed Batista that his unnecessary contacts with third-parties was damaging his law practice.

31. The last disclosure of Payne's tax return information by Batista was made to Glenn Fogle in 1995; however, by the time of the trial, Payne was still asked by people whether he has resolved his situation with the IRS.

32. By August of 1996, Payne's law firm was not expanding or receiving new cases.

33. Payne and Payne and Associates, Inc. experienced a significant drop in gross receipts because of the unauthorized disclosures of tax return information made by Batista.

34. James Hill ("Hill") conducted a financial analysis of Payne's law firm. Hill prepared a best case, a worst case, and an average case scenario. He determined the overall lost profits to Payne's law practice and brought that figure back to the present value. There was a severe drop in gross receipts to Payne and Payne and Associates, Inc. between 1993 and 1994 after a steady growth rate for seven (7) to eight (8) years. Hill testified that some event caused this severe drop in gross receipts. However, Hill stated, a number of events could have caused the decline. Hill calculated the damage to Payne and Payne and Associates, Inc. at 3.3. million dollars based on the average case scenario and with Payne working through age seventy (70). Hill then recalculated the figures with the assumption that Payne would retire that the age of sixty (60). The damage amount still totaled 3.3 million dollars. Hill recalculated the damages to Payne and Payne and Associates, Inc. using a discount rate for 1994 through 1997.

35. There are several methods of proof that an agent

may use to prove criminal tax liability, including the specific item method and the bank deposit method. Although both methods permit an agent to corroborate admissions and evidence, neither method requires agents to first seek out third-parties. Furthermore, corroboration under either method of proof implies that the taxpayer is given an opportunity to provide the needed information first. Since Payne was not afforded such an opportunity, the type of method of proof used by Batista during the investigation is irrelevant to the discussion of whether there was an unauthorized disclosure of Payne's confidential tax return information.

36. The special agent should provide the taxpayer with a specific list of what he is seeking. The agent should always ask the taxpayer for records first regardless of the method of proof he intends to use. The method of proof that the agent decides to use is inconsequential if the taxpayer is willing to cooperate. If the taxpayer is not cooperating and the specific item method of proof is being used then the agent would need to contact witnesses. However, it is not necessary to go to every client of the taxpayer to corroborate canceled checks.

37. The special agent needs to work with the taxpayer to whatever degree is required to secure the needed records. It is not necessary to contact all of a taxpayer's customers or clients if the taxpayer is willing to provide the records himself. Moreover, if the

taxpayer is willing to get the records from the bank or third-parties then the agent should give the taxpayer an opportunity to do that. Disclosures of confidential return information harm the reputation of the taxpayer.

38. In addition, while it is not necessary for an agent to identify himself as a special agent with the criminal investigation division of the IRS, in *Gandy v. United States*, 234 F.3d 281 (5th Cir. 2000), the Fifth Circuit ruled that provisions of the Special Agent's Handbook, and Treasury Regulations clearly provide that agents are authorized to display their credentials and badges identifying them as Criminal Investigation Division agents when interviewing a third party. The Court concluded that an agent's knowledge that his badge identifies his area of investigation supports a reasonable agent's conclusion that he is authorized to orally disclose that he is conducting a criminal investigation.

39. Batista acknowledged that, as a general rule, where the taxpayer is aware of the investigation and is cooperating, the special agent should obtain information directly from the taxpayer or the taxpayer's representative. Batista also recognized that the special agent should be discreet. The IRS regulations are clear and unambiguous. Batista knows that he is required to follow these regulations. Batista is also charged with being familiar with the IRS

agents' handbooks. Batista received training on disclosure of confidential tax return information.

40. Regardless of the degree of Payne's cooperation, Batista would still have to get some information from his bank. For example, Batista would need to secure a copy of the signature cards. Batista acknowledged that he could have requested the documentary evidence from Payne; however, he did not ask Payne for such information.

41. Batista did not give Payne a fair opportunity to provide the records first before Batista contacted third-parties. Batista could have conserved the IRS's resources and allowed Payne to provide the information. Batista did not comply with IRS standards of conduct for special agents. It was not necessary for Batista to contact all of Payne's clients. Furthermore, he failed to use his best efforts to obtain the information voluntarily from the taxpayer. Moreover, Batista did not limit the effects of his disclosures as required by IRS regulations, especially as it related to his suggestion of drug activity by Payne.

CONCLUSIONS OF LAW

1. Section 6103 of Title 26 "forbids the disclosure of return information." *Huckaby v. United States*, 794 F.2d 1041, 1046 (5th Cir. 1986) (citing 26 U.S.C. §

6103(a)); *Barrett v. United States*, 795 F.2d 446, 449 (5th Cir. 1986). In particular, Section 6103 states that:

> [r]eturn and return information shall be confidential, and except as authorized by this title . . . no officer or employee of the United States . . . *shall disclose any return or return information* obtained by him in any manner in connection with his service as such an officer or an employee or otherwise or under the provisions of this section.

26 U.S.C. § 6103(a) (emphasis added). Thus, as a general rule, returns and return information shall be confidential. *Barrett*, 795 F.2d at 449. "The need to minimize disclosures is particularly important when it is remembered 'that our voluntary assessment system of tax action is in large measure dependent upon the realization of a taxpayer's expectation that the information required of him for this purpose would be kept confidential.'" *Diamond v. United States*, 944 F.2d 431, 434 (8th Cir. 1991) (quoting *Flippo v. United States*, 670 F. Supp. 638, 642 (W.D.N.C. 1987) (emphasizing that Congress realized this fact when enacting Section 6103); see *Johnson v. Sawyer*, 640 F. Supp. 1126, 1132 (S.D. Tex. 1986) ("Congress enacted . . . [Section] 6103 to protect taxpayers' reasonable expectation that information submitted to the IRS would remain confidential.").

2. Section 6103(b) defines "return information" broadly, to include:

> a taxpayer's identity, the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessment, or tax payments, whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense . . . .

26 U.S.C. § 6103(b)(2)(A); see *Barrett*, 795 F.2d at 449; *Johnson v. Sawyer*, 640 F. Supp. 1126, 1129 (S.D. Tex. 1986) (noting that the term "return information" is broad and encompasses "any information gathered by the IRS regarding a person's tax liability). Thus, "[r]eturn information includes the taxpayer's identity, the fact that the taxpayer is under investigation or subject to further investigation, and data that the IRS

has collected about a return." *Huckaby*, 794 F.2d at 1046.

3. "The term 'disclosure' means the making known to any person in any manner whatever a return or return information." 26 U.S.C. § 6103(b)(8). An agent cannot make a decision regarding the method of proof without any regard to the limitations placed on his conduct by Section 6103.

4. The third-party contacts made by Batista through phone calls, in-person meetings, and fax cover letters concerning the IRS's criminal investigation of Payne constitute disclosures of Payne's confidential return information. In particular, Batista's identifying himself as a member of the Criminal Investigation Division and informing third-parties that Payne was under a criminal investigation by the IRS disclosed return information about Payne. See *Diamond*, 944 F.2d at 434. Section 6103 expressly defines return information as "whether the taxpayer's return was, is being, or will be examined or subject to other investigation." 26 U.S.C. § 6103(b).

5. Section 6103 also includes several exceptions to this general prohibition on disclosure. In particular, Section 6103(k)(6) provides that:

> [a]n internal revenue officer of employee may, in connection with his official duties

> relating to any audit, collection activity, or civil or criminal tax investigation or any other offense under the internal revenue laws, disclose return information to the extent that *such disclosure is necessary* in obtaining information, which is *not otherwise reasonably available*, with respect to the correct determination of tax, liability for tax, or the amount to be collected or with respect to the enforcement of any other provision of this title. *Such disclosures shall be made only in such situations and under such conditions as the Secretary may prescribe by regulation.*

26 U.S.C. § 6103(k)(6) (emphasis added). Thus, Section 6103(k)(6) allows an IRS officer or employee to disclose return information "to the extent that such disclosure is necessary in obtaining information, which is not otherwise reasonably available, with respect to the correct determination of tax, liability for tax, or the amount to be collected . . . . " 26 U.S.C. § 6103(k)(6); see *Barrett*, 795 F.2d at 449. However, such disclosure may only be made "in such situations and under such conditions" as the Secretary of the Treasury may prescribe. 26 U.S.C. § 6103(k)(6). The court does "not question the right, wisdom, or necessity of a particular IRS investigation[,]" but does "question . . . the means of investigation, but only to the limited extent

consistent with Section 7431" of Title 26, which provides a civil cause of action for improper disclosures of return information. *Barrett,* 795 F.2d at 451.

6. With respect to summonses, the Treasury Regulations state that:

> the Commissioner is authorized to summon the person liable for the tax or required to perform the act, or any officer or employee of such person or any person having possession, custody, or care of books of accounts containing entries relating to the business of the person liable for tax or required to perform the act, or any other person deemed proper, to appear before a designated officer or employee of the Internal Revenue service . . . and to give such testimony under oath, as may be relevant or material to such inquiry; and take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry. This summons may be used in an investigation of either civil or criminal tax-related liability. The Commissioner may designate any employee of the Internal Revenue Service as the individual before whom a person summoned . . . shall appear. Any such

> employee, when so designated in the summons, is authorized to take testimony under oath of the person summoned and to receive and examine books, papers, records, or other data produced in compliance with the summons.

Treas. Reg. § 301.7602-1(b).

7. The Treasury Regulations also provide that, in connection with official duties, an officer or employee of the IRS may disclose taxpayer identity information, "the fact that the inquiry pertains to the performance of official duties, and the nature of the official duties in order to obtain necessary information relating to performance of such official duties[.]" Treas. Reg. § 301.6103(k)(6)-1(a). However, disclosure of taxpayer identity information to a person other than the taxpayer at issue should be made

> only if the necessary information cannot, under the facts and circumstances of the particular case, otherwise reasonably be obtained in accurate and sufficiently probative form, or in a timely manner, and without impairing the proper performance of the official duties, or if such activities cannot otherwise properly be accomplished without making such disclosure.

Id. An IRS officer or employee may also disclose return information in order to obtain necessary information relating to the following:

> (1) To establish or verify the correctness or completeness of any return . . . or return information;
>
> (2) To determine the responsibility for filing a return, for making a return where none has been made, or for performing such acts as may be required by law concerning such matters;
>
> (3) To establish or verify the liability (or possible liability) of any person, or the liability (or possible liability) at law or equity of any transferee or fiduciary of any person, for any tax, penalty, interest, fine, forfeiture, or other imposition or offense under the internal revenue laws or the amount thereof to be collected;
>
> (4) To establish or verify misconduct (or possible misconduct) or other activity proscribed by the internal revenue laws;
>
> (5) To obtain the services of persons having special knowledge or technical skills . . . or having recognized expertise

> in matters involving the valuation of property where relevant to proper performance of a duty or responsibility described in this paragraph;
>
> (6) To establish or verify the financial status or condition and location of the taxpayer against whom collection activity is or may be directed, to locate assets in which the taxpayer has an interest, to ascertain the amount of any liability . . . to be collected, or otherwise to apply the provisions of the Code relating to establishment of liens against such assets, or levy on, or seizure, or sale of, the assets to satisfy any such liability; or
>
> (7) To prepare for any proceedings described in section 6103(h)(2) or conduct an investigation which may result in such a proceeding, or where necessary in order to accomplish any activity described in subparagraph (6) of this paragraph.

Treas. Reg. § 301.6103(k)(6)-1(b). Again, a disclosure of return information to someone other than the taxpayer being investigated should only be made if such information cannot otherwise be reasonably obtained. *Id.*

8. The IRS provides conduct guidelines for Special Agents during investigations as follows:

a. All returns and return information are confidential and may not be disclosed except as authorized by the Internal Revenue Code . . . [C]ivil actions for damages are permitted against the Government [for unauthorized disclosures] . . . The fact that a person has filed a tax return or is under investigation is [return information] . . . Disclosure is the making known of returns or return information in any manner. A disclosure may be either direct or indirect.

Internal Revenue Manual – Administration, Special Agents Handbook, ¶¶ 348.1-348.2.

b. Tactful – As professionals, special agents should always exercise good judgment. He/she should be tactful in all aspects of the investigation so that actions and/or remarks are not likely to be misinterpreted.

Internal Revenue Manual – Administration, Investigative Procedures, ¶ 9382.1(3).

c. Discreet – A special agent should be discreet in all investigations conducted. He/she must not make statements or ask questions that will divulge information which would tend to jeopardize the successful conclusion of the investigation. He/she must not unnecessarily injure the reputation of the person being investigated.

Internal Revenue Manual – Administration, Investigative Procedures, ¶ 9382.1(4).

d. All criminal investigations should be started and concluded as expeditiously as possible. They should be conducted impartially and thoroughly to obtain all critical information and evidence. Duplication in investigations, unnecessary inconveniences to the public and unnecessary embarrassment to the taxpayer should be avoided. Appropriate courtesies should be shown when soliciting information.

Internal Revenue Manual – Administration, Policies of the IRS Handbook, ¶ P-9-29.

e. As a general rule, in instances when the taxpayer is aware of the investigation, is

> cooperating, and is believed to have the needed information, special agents should obtain such information directly from the taxpayer or the taxpayer's representative unless to do so might tend to prejudice the investigation.

Internal Revenue Manual – Administration, Special Agents Handbook, § 348.3.

f. A special agent should use his/her best efforts to obtain information voluntarily from taxpayers and witnesses.

Internal Revenue Manual – Administration, Special Agents Handbook, ¶ 363.

g. Detrimental effects to be avoided are:

> 1. unnecessary embarrassment to the principal.
>
> 2. needless disclosure of the Government's affairs or information of a confidential nature ... In any event, whenever the special agent first officially meets with the subject of the investigation, he/she should be introduced as "Special agent, Internal Revenue Service," and will produce

his/her credentials for examination.

Internal Revenue Manual – Administration, Special Agents Handbook, §§ 3(10)8.1(5)(c), 3(10)8.1(7), 3(10)8.11(5)(c).

h. Mail circularization is a written request to third parties for information where more than ten letters of a similar nature are sent. Mail circularization to obtain third party evidence may be, under certain circumstances, the most practical means of obtaining documentary evidence in an investigation when a large number of persons, widely scattered geographically, need to be reached. If not judiciously used, mail circularization may result in unwarranted embarrassment to the taxpayer . . . . A special agent should exercise caution not to damages the reputation of the taxpayer by making the letter either offensive or suggestive of any wrongdoing by the taxpayer.

Internal Revenue Manual – Administration, Special Agents Handbook, ¶¶ 347.1, 347.2(3).

9. The fact that an agent has given prior "in court" testimony relative to the taxpayer's "return information," which likely removes this information

from its otherwise "confidential" cloak, does not justify the agent's violation of the requirement that he, as an officer of the United States, is prohibited from disclosing "return information" absent express statutory authorization. See *Johnson v. Sawyer*, 120 F.3d 1307, 1318-19 (5th Cir. 1997); *Rodgers v. Hyatt*, 697 F.2d 899, 906 (10th Cir. 1983); *Mallas v. United States*, 993 F.2d 1111, 1120 ("The Government points to no such exception – and we are aware of none – permitting the disclosure of 'return information' simply because it is otherwise available to the public."). Simply because "'an event is not wholly 'private' does not mean that an individual has no interest in limiting disclosure or dissemination of information.'" *Mallas*, 993 F.2d at 1120 (quoting *United States Dep't of Justice v. Reporters Comm. for Freedom of the Press*, 489 U.S. 749, 109 S. Ct. 1468, 1480, 103 L. Ed. 2d 774 (1989)(citations omitted)); see *Johnson*, 120 F.3d at 1318-19.

10. Under Section 7431(a)(1) of Title 26, a taxpayer may bring a civil action for damages against the United States for knowing or negligent disclosure of returns or return information by United States employees. 26 U.S.C. § 7431(a)(1). Section 7431(a)(1) states, in pertinent part, that "[i]f any officer or employee of the United States knowingly, or by reason of negligence, inspects or discloses any return or *return information* with respect to a taxpayer in violation of any provision of section 6103, such taxpayer may bring

a civil action for damages against the United States in a district court of the United States." 26 U.S.C. § 7431 (a)(1) (emphasis added). Thus, to obtain damages for wrongful disclosure under Section 7431(a)(1), a plaintiff must prove: (1) that a government employee knowingly or negligently disclosed confidential tax return information; and (2) that the disclosure was not authorized by Section 6103. *Wilkerson v. United States*, 67 F.3d 112, 115 (5th Cir. 1995).

11. Without first determining whether the information sought was otherwise reasonably available, Batista contacted a large number of Payne's clients, several of his business associates, friends, relatives, and employees of state and local law enforcement agencies. Batista disclosed numerous items of return information to these persons. For example, on several occasions, when making these third-party contacts, Batista disclosed the fact that Payne was under criminal investigation by the IRS. Furthermore, there was no evidence that any of the disclosures of Payne's confidential return information, either through phone calls, in-person meetings or fax cover pages, were necessary to obtain the information that Batista sought. Nonetheless, nine of the fax cover pages sent by Batista are not actionable, because they were not actual disclosures of the criminal nature of the investigation, as they were either transmitted to third-parties who already knew of the criminal nature of the investigation, because they received copies of the

Payne's petition to quash the summonses, or they were transmitted to third-parties who Batista had previously spoken with and identified himself as a Criminal Investigation Division agent, or had presented his credentials. The Court holds that it was not necessary for Batista to disclose the various items of return information to the third-parties that Batista contacted by telephone, in-person, or by fax, especially since the information repeatedly offered by Payne and refused by Batista was ultimately delivered to Gregory Gallagher of the United States Department of Justice, Tax Division, Criminal Section. The Court further holds that such disclosures were made knowingly or by reason of negligence, and thus, were in violation of Section 6103, however, the good faith exception operates to protect the United States from liability for all of the oral disclosures of the criminal nature of the investigation and the written disclosures made in the three fax-cover pages sent to financial institutions.

12. Batista also asked numerous third-parties, including clients of Payne, questions about whether or not Payne used or was involved in illegal drugs. Batista contends that a witness allegedly told him that Payne was involved in drugs or other criminal activity, however, Batista could not remember the name of the witness or whether such information was obtained during a formal or informal interview. The Court finds that there was no rational basis for Batista to ask these questions particularly in light of IRS regulations

that require special agents to avoid "unnecessarily injuring the reputation of the person being investigated." Internal Revenue Manual – Administration, Investigative Procedures, ¶ 9[illegible]2.1(4).

13. Recovery under Section 7431(a)(1) must be denied if the disclosure "results from a *good faith*, but erroneous interpretation of section 6103." 26 U.S.C. § 7431(b)(1) (emphasis added). The "good faith" exception protects the United States from liability where the alleged violation arises from a good-faith misunderstanding of Section 6103. See 26 U.S.C. § 7431(b)(1). In determining whether an agent has behaved in "good faith," the Fifth Circuit has adopted the following objective standard: officials act "in good faith when 'their conduct does not violate clearly established statutory or constitutional rights of which a reasonable person would have known.'" *Huckaby*, 794 F.2d at 1048 (quoting *Harlow v. Fitzgerald,* 457 U.S. 800, 102 S. Ct. 2727, 2738, 73 L. Ed. 2d 396 (1982)). "A reasonable IRS agent can be expected to know the provisions of Sections 6103 and 7431, as they may be further clarified by IRS regulations and other IRS interpretations." *Huckaby,* 794 F.2d at 1049; *Heller v. Plave*, 657 F. Supp. 95, 98 (S.D. Fla. 1987). "An agent's contrary interpretation is not in good faith." *Barrett v. United States*, 51 F.3d 475, 479. [In *Gandy v. United States*, 234 F.3d 281, 286 (5th Cir. 2000), the Fifth Circuit ruled that because of the differences in the nature of circular letters or mass mailings and

personal contact where oral disclosures are ordinarily made, a reasonable agent would conclude that the specific rules prohibiting written disclosure of the criminal nature of investigations would not apply to all disclosures, including oral disclosures. Furthermore, the Fifth Circuit explained that an agent's knowledge that he is authorized to display his credentials which identify him as Criminal Investigation Division agents, supports a reasonable agent's conclusion that he may verbally disclose the nature of his investigation to third parties. *Id.* The Court concluded that the good faith exception excuses oral disclosures of the criminal nature of investigations, because a reasonable agent may conclude that he is authorized to orally disclose that he is conducting a criminal investigation. *Id.*

14. Applying an objective good-faith test, consistent with *Gandy,* to the facts of this case, the Court finds that Batista's oral disclosures to third-parties of the criminal nature of the investigation, while unnecessary, were in good faith. Also, the three fax cover sheets sent to the financial institutions, which also unnecessarily stated that the words "Criminal Investigation Division," were transmitted by Batista in good faith. These three fax cover sheets, contained in Plaintiff's exhibits 98, 101 and 102 where each transmitted prior to June 12, 1992. At this time, a special agent reading Section 347.2 of the Internal Revenue Manual, Special Agents Handbook, would have been informed that the restrictions, which

reference circular letters provided that the use of the words "Criminal Investigation Division" was still appropriate in letter head and signature blocks. Internal Revenue Manual § 347.2 provided in relevant part:

> Any reference to the Criminal Investigation Division must be restricted to the signature blocks or ancillary headings . . . . The title "Special Agent" and Criminal Investigation Division will be included in the signature block.

Accordingly, because there is no specific regulation which references fax cover pages, based on this provision in the Special Agent's Handbook, a reasonable agent would not have concluded that the use of the words "Criminal Investigation Division" on the fax cover page was improper, because the sender's address on the fax cover page may be appropriately considered an ancillary heading. Therefore, the three faxes to the financial instructions containing this language sent by Batista before June 12, 1992 were disclosures of the criminal nature of the investigation however, they fall within the good faith exception.

15. As for Batista's comments regarding whether Batista was involved in illegal drugs, the court finds that such suggestions ". . . depict a lack of integrity on the part of the government. Such careless conduct

must be reprimanded. The responsibilities of the IRS are gravely important and should not be tainted by irresponsible comments." *Heller*, 657 F. Supp. at 99. The government "must bear responsibility for improper disclosures. Section 6103 acts as a restraint on unsuitable behavior among IRS agents and mandates the protection of our government's rectitude." *Id.*

16. "Once liability attaches, a court must make determination of damages consonant with" Section 7431(c). *Barrett v. United States*, 100 F.3d 35, 38 (5th Cir. 1996). Section 7431 provides that:

> [i]n any action brought under subsection (a), upon a finding of liability on the part of the defendant, the defendant shall be liable to the plaintiff in an amount equal to the sum of–
>
> (1) the greater of–
>
> (A) *$ 1,000 for each act of unauthorized inspection or disclosure* of a return or return information with respect to which such defendant is found liable, or
>
> (B) the sum of –
>
> (i) *the actual damages sustained by the plaintiff*, as a result of such unauthorized inspection or disclosure, plus
>
> (ii) in the case of a willful

> inspection or disclosure or an inspection or disclosure which is the result of gross negligence, *punitive damages*, plus
>
> (2) the costs of the action.

26 U.S.C. § 7431(c) (emphasis added). Specifically, Section 7431 "limits actual damages to those 'sustained . . . as a result of [an] unauthorized disclosure.'" Barrett, 100 F.3d at 40 (quoting 26 U.S.C. § 7431(c)(1)(B)(i)).

17. In *Barrett v. United States*, 917 F. Supp. 493, 495 (S.D. Tex. 1995), the court examined whether the plaintiff, a plastic surgeon, had proved that actual damages "were inflicted by the disclosure of the criminal investigation in circular letters" sent by the IRS. The plaintiff's position was that, "but for the circular letters, his [medical] practice would have been more substantial. The patients of a plastic surgeon are particularly concerned that their privacy be maintained." *Id.* at 496. The plaintiff then argued that "when 260 [of his] patients received this letter, they would have become angry with . . . [him] because their privacy had been breached[.]" *Id.* Furthermore, according to the plaintiff, "when the patients read that . . . [he] was under criminal investigation, they would have thought less of . . . [him] as a law abiding citizen." *Id.* Consequently, the plaintiff "maintained that both of these circumstances would render the patients

disinclined to return to him for further plastic surgery and to recommend him to their friends." *Id.*

The court held that "the decrease in patients was [likely] a result of a combination of factors, the most unlikely of which, given the totality of evidence, was the disclosure in the IRS letter." *Id.* at 502. The court emphasized that "any actual damages must have arisen from the disclosure to the patients of the criminal investigation and not from the concern of the patients that their privacy had been breached." *Id.* In fact, the court found that there was no "evidence that any physician had, in fact, not referred patients [to the plaintiff] because of the letters[.]" *Id.* at 496. The plaintiff, himself, admitted that he has never identified one patient who had refused, either as a result of the disclosures or out of privacy concerns, to see him or any doctors that declined to refer patients to him. *Id.* at 499. Furthermore, "the testimony of the physicians among the witness all emphasized that . . . [the plaintiff] enjoyed an excellent reputation as a surgeon." *Id.* The Court then criticized the expert certified public accountant's "lost income model," his assumption of causation, and his failure to "differentiate the damage that he maintained was caused by the improper disclosure in the circular letters from the damage that the many other [identified] factors that could have contributed to the drop in the number" of the plaintiff's patients. *Id.* at 502. Given that only speculation connected the loss in patients to the unlawful

disclosures, the court determined that the plaintiff had failed to prove that he suffered actual damages from the improper disclosures in the circular letters. *Id.* at 497-502.

18. Unlike the situation in *Barrett*, Payne presented evidence that the damage he sustained to his law practice and law firm was caused by the improper disclosures by Batista. Shaddox testified that there was a noticeable change in the level of business activity, including client referrals, in Payne's law firm after the third-party contacts were made by Batista. In addition, Schindler, a former client of Payne who was contacted by Batista, indicated that he would not use Payne's legal services again or refer any additional clients to Payne because of the outstanding criminal investigation by the IRS. Talmadge, another client of Payne's who was contacted by Batista, stated that he would not have known about the criminal investigation of Payne if he had not received a phone call from Batista. When asked by co-workers about Payne's legal services, Talmadge informed them about the IRS investigation. Consequently, Talmadge's co-workers did not contact Payne.

Furthermore, Hill, Payne's expert witness, testified that there was a severe drop in gross receipts to Payne's law firm between 1993 and 1994 after a steady growth rate for seven (7) to eight (8) years. Although Hill did not attempt to conclusively establish the cause of this severe drop in gross receipts, the

United States did not offer any additional theories for the loss that Payne suffered. *Cf. Barrett*, 917 F. Supp. at 495 (noting the United States's opposition to the taxpayer's requested actual and punitive damages award and emphasis that it vigorously contested the taxpayer's damage claims at trial on cross examination, namely, by offering additional theories of causation). In this case, there is more than mere speculation to support the conclusion that the decline in clients and client referrals was caused by Batista's disclosure of the criminal nature of the investigation. The evidence of damages presented by Plaintiff is based on the disclosure of the criminal nature of the investigation to clients and potential clients. However, this Court has already determined that Batista's oral disclosures and written disclosures of the criminal nature of the investigation found in fax cover sheets, are protected by the good faith exception. There is no evidence that Payne suffered actual damages as a result of Batista's comments that he may be involved in drugs. Also, even if nine of the twelve fax cover pages, containing the words "Criminal Investigation Division" were actionable, these faxes were sent to financial institutions, where Payne held accounts. The evidence presented on damages during trial was based on the reduction of his law firm revenues, and not on the loss of any loans or credit from financial institutions. Accordingly, there is no basis upon which the Court can award recovery to Payne.

19. Nonetheless the Court feels obligated to find that the conduct exhibited by Batista was egregious. For example, Batista testified that he never calls to make an appointment, but rather arrives at the taxpayer's location, his place of residence or business, unannounced. Batista, however, acknowledged that he was not prohibited from calling Payne in advance to schedule an appointment. Furthermore, Batista made devastating disclosures regarding Payne's suspected involvement in illegal drugs to Payne's clients, business associates, friends, and relatives. Batista, incredulously, maintained that asking third-parties whether a person was a drug dealer would not hurt that person's reputation. In particular, Batista attempted to convince the Court that he sought to protect Payne's reputation by distinguishing between "asking" whether Payne was a drug dealer and "saying" that Payne was a drug dealer. According to Batista, a simple inquiry would not injure that person's reputation. The Court finds this testimony to be insincere and entirely reflective of Batista's cavalier attitude. Moreover, as mentioned, under Section 6103, an IRS agent has discretion to disclose return information to the extent that the information is necessary and not otherwise reasonably available. 26 U.S.C. § 6103. Batista grossly abused that discretion. Batista made a number of third-party contacts without first giving Payne an opportunity to provide the needed information. Batista also initially insisted that there was no requirement that an agent obtain as much

information as possible from the taxpayer before contacting third-parties. Later, Batista admitted that his conduct violated the IRS manual and regulations. In addition, Batista had no rational explanation for his conclusion that Payne was not being sincere about his willingness to cooperate and his desire to assist Barista in the investigation. However, because Payne was unsuccessful in identifying disclosures by Batista of the criminal nature of the investigation, in particular, which were either actionable, or not protected by the good faith exception, the Court is unable to award, punitive damages or attorney's fees for Batista's outrageous conduct. Payne is not a prevailing party as that term is used in 26 U.S.C. § 7430, therefore he is not entitled to attorneys fees under Section 7430.

21. Payne's agitation with Batista's course of conduct is understandable. See *Diamond*, 944 F.2d at 434. "In our society, even without an actual conviction, the suggestion of criminal activity can transform and devastate an individual's life[.]" *Id.* In Payne's case, it destroyed the confidence of his clients in their lawyer and of others in a potential lawyer, leaving Payne without a practice. However, consistent with the Fifth Circuit's ruling in *Gandy*, Batista's oral disclosures of the criminal nature of his investigation against Payne, were initially made when Batista's identified himself as a special agent in the Criminal Investigation Division or presented his credentials, these type of oral disclosures are protected by the good faith exception.

Furthermore, the written disclosures which revealed the criminal nature of the investigation are also protected by the good faith exception. Accordingly, Payne cannot recover damages and the Court **ORDERS** that Payne takes nothing in this case.

The Clerk shall enter this Order and provide a copy to all parties.

SIGNED this 10th day of September, 2003.

/s/_____

VANESSA D. GILMORE
UNITED STATES DISTRICT JUDGE

AMENDED FINAL JUDGMENT

Based on the Court's Amended Findings of Fact and Conclusions of Law, dated September 10, 2003, the Court finds in favor of the United States. The Plaintiff takes nothing in this case.

This is a **FINAL JUDGMENT.**

The Clerk shall enter this Order and provide a copy to all parties.

Signed on this the 10th day of September, 2003, at Houston, Texas.

/s/_____
VANESSA D. GILMORE
UNITED STATES DISTRICT JUDGE

APPENDIX C

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 03-21031

JERRY S. PAYNE; ET AL
Plaintiffs

JERRY S. PAYNE
Plaintiff -Appellant

v.

UNITED STATES OF AMERICA; ET AL
Defendants

UNITED STATES OF AMERICA
Appellee

U.S. COURT OF APPEALS
FILED
NOV 05 2004
CHARLES R. FULBRUGE III
CLERK

Appeal from the United States District Court for the Southern District of Texas, Houston

ON PETITION FOR REHEARING EN BANK

(Opinion 9/8/04, 5 Cir., _____, _____ F.3d_____)
Before KING, Chief Judge, and DeMOSS, and STEWART, Circuit Judges,

PER CURIAM;

(X) Treating the Petition for Rehearing En Banc as a Petition for Panel Rehearing, the Petition for Rehearing En Banc is DENIED. No member of the panel nor judge in regular active service of court having requested that the court be polled on Rehearing En Banc (FED R. APP. P. AND 5TH CIR. R. 35), the Petition for Panel Rehearing is DENIED.

ENTERED FOR THE COURT:

/S/_____
United States Circuit Judge

CLERK'S NOTE:
SEE FRAP AND LOCAL RULES 41 FOR STAY OF THE MANDATE.

~~REHG-6a~~

APPENDIX D

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

No. 00-20107

JERRY S. PAYNE; et al.,

Plaintiffs,

JERRY S. PAYNE,

Plaintiff-Appellant

v.

UNITED STATES OF AMERICA; et al.,

Defendants

UNITED STATES OF AMERICA,

Defendant-Appellant-Cross-Appellee

Appeals from the United States District Court
for the Southern District of Texas

May 7, 2002

Before POLITZ and EMILIO M. GARZA, Circuit Judges, and KAZEN, District Judge.*

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* Honorable George P. Kazen, Chief United States District Judge for the Southern District of Texas, sitting by designation.

KAZEN, Chief District Judge:

The United States appeals the verdict of the district court following a bench trial in which the court found the United States liable for a violation of I.R.C. § 7431. The district court's findings of fact and conclusions of law are set forth at 91 F. Supp. 2d 1014 (S.D.Tex 1999). In sum, the trial court determined that IRS Special Agent David Batista made unlawful disclosures of taxpayer Jerry S. Payne's confidential return information in violation of I.R.C. § 6103, and that these violations were not the result of a "good faith, but erroneous" interpretation of law. I.R.C. § 7431(b). The court awarded Payne $1,536,680 in actual damages, $1,000 in punitive damages, and $105,361 in attorneys fees and costs. For reasons hereinafter discussed, we REMAND for further findings.

I. Factual Background

In the fall of 1989, the Internal Revenue Service began a civil audit of 2618, Inc., a Texas corporation that operated a topless dance club under the name Caligula XXI. Jerry Payne, an attorney, became the owner of 2618, Inc. in 1988 as compensation for legal

services for the then-owner, Gerhard Helmle. The IRS agent conducting the audit, Colin Levy, suspected fraud and referred the case to the IRS Criminal Investigation Division. The investigation of Payne was assigned to Special Agent Batista.

In October 1991, Batista and Levy arrived unannounced at Payne's law offices to inform Payne of the initiation of the investigation. At that time, Batista produced a summons for business and financial records associated with 2618, Inc. In response, Payne declared his willingness to cooperate fully and to provide the requested information in a timely manner. Batista was satisfied with the sincerity of Payne's stated intent to cooperate.

In December 1991, Batista began to contact third-parties seeking information regarding payments to Payne. For example, on December 19, 1991, Batista contacted the Texas Lawyers Insurance Exchange to inquire about a $36.00 payment it had made to Payne. Batista conceded that he could have obtained this information from Payne and that doing so would not have prejudiced his investigation. At trial, Batista admitted to making other third-party contacts as early as December 1991, and that he began to inquire into

allegations of Payne's involvement with illegal drugs. Although Payne voiced concern over these contacts, he and Batista agreed on January 16, 1992 to a timetable for the voluntary production of 2168, Inc.'s records. A week later, Batista and Levy came to Payne's office to review and microfilm documents. Batista testified that, as of this date, he was happy with Payne's performance, cooperation, and his efforts to produce needed information.

From October of 1991 to July of 1992, Payne sent numerous letters to Batista requesting him to clarify the issues under investigation. The gist of these letters was that Payne wanted to know the scope of the inquiry so that he could provide Batista with relevant information in a manner that would preserve the confidentiality of the investigation. In his correspondence, Payne repeatedly conditioned his continued cooperation on Batista's agreeing to more specifically define the scope of his inquiry. Batista never responded to Payne's requests for a listing of specific areas of concern. On March 2, 1992, Batista and his supervisor Swayzine Fields met with Payne at Payne's office. During this meeting, Batista requested any work papers for Payne's 1987 and 1988 personal

tax returns. Payne agreed to provide them. This was the first and only documented request for information relating to Payne's personal tax returns, although Batista testified that he made a previous oral request for the papers. Payne later informed Batista that he did not have any work papers for those returns.

By March of 1992, Batista apparently decided that Payne did not sincerely intend to cooperate with the investigation. At trial, Batista initially could not recall any specific incident that led him to this conclusion, but he eventually testified that the tone of Payne's letters gave him the sense that Payne would not fully disclose information without the imposition of untenable conditions. The district court concluded that Batista "had no rational explanation" for this conclusion. *Payne*, 91 F. Supp. at 1029. In any event, Batista accelerated the pace of his investigation during and after March 1992. In that month, Batista sent out ten summonses to various corporations and banks seeking bank statements, canceled checks, deposit slips and deposited items, loan applications/agreements and related records. During and after that month, Batista interviewed employees and officers of 2618, Inc. in person, introducing himself as a criminal investigator

with the IRS who was investigating Payne's possible violation of criminal revenue laws. Batista asked some of the employees and some of Payne's relatives if they knew whether Payne used or sold illegal drugs. Batista contacted Payne's clients and former clients mostly by mail, issuing summonses for copies of any retainer agreements, expense reimbursement statements, or cancelled checks of payment. Batista also spoke with some of these clients over the telephone and interviewed some in person. During the course of the investigation, Batista issued a large number of summonses and letters to third-parties that disclosed on their face that Payne was under criminal investigation, and he revealed that fact during his in-person interviews.

In March of 1993, Batista terminated his investigation of Payne and recommended the case to the Justice Department for criminal prosecution. For the first time, an attorney for the Justice Department informed Payne of particular issues of concern, and in response Payne provided information that led the United States to conclude that criminal prosecution was not warranted for all the matters recommended by Batista. In 1995 Payne was indicted on two counts of

violating I.R.C. § 7206 relating to tax fraud and three counts of violating I.R.C. § 7203 relating to failure to file tax returns. The trial court dismissed the § 7206 charges, and a jury acquitted Payne of the § 7203 charges.

Following the criminal trial, the IRS completed its civil examination and issued Payne a notice of deficiency for 1987 and 1988 individual income taxes and civil fraud penalties. The United States Tax Court entered a decision determining Payne's individual income tax for those years, and sustaining the fraud penalties. *Payne v. Commissioner*, 75 T.C.M. (CCH) 2548, 2565, 1998. This court reversed. *Payne v. Comm'r of Internal Revenue*, 224 F.3d 415, 424 (5th Cir. 2000). The panel found that the tax court erred in ruling that the United States had proven fraud by "clear and convincing" evidence and thus erroneously relied on the statutory fraud exception to prevail over the applicable statute of limitations. *Id.*

Payne then filed this suit in the district court, seeking damages from the United States and several IRS agents for their actions in conducting the investigation. The district court dismissed all defendants other than the United States, and all

claims other than the wrongful disclosure of tax information claim. This claim was tried to the court, and at the conclusion of the trial, the court held as follows: (1) Batista made a large number of third-party contacts in the course of his investigation of Payne without first determining whether the information sought was otherwise reasonably available; (2) Batista did not consider himself under any obligation to seek necessary information from Payne; (3) Batista disclosed numerous items of return information to these third parties, including the fact that Payne was subject to a criminal investigation; (4) there was no evidence that any of the disclosures of return information were necessary to obtain the information Batista sought; (5) Batista's disclosures did not result from a good faith but erroneous interpretation of the applicable statutory provision; (6) Batista's improper disclosures damaged Payne's law practice; (7) Batista grossly abused his discretion in making the numerous third-party contacts without first affording Payne the opportunity to provide the needed information, and in particular by inquiring about Payne's involvement with illegal drugs; and (8) the United States' litigation position was unreasonable given that Batista made no determination as to whether the information he sought was otherwise reasonably available.

II. Standard of Review

We review the district court's findings of fact for clear error and conclusions of law de novo. *Dunbar Medical Systems, Inc. v. Gammex Inc.*, 216 F.3d 441, 448 (5th Cir. 2000). Similarly, as to mixed questions of law and fact, we review the district court's fact findings for clear error, and its legal conclusions and application of law to fact de novo. *Sugar Busters, LLC v. Brennan*, 177 F.3d 258, 269 (5th Cir. 1999). In reviewing factual findings for clear error, we defer to the findings of the district court unless we are left with a definite and firm conviction that a mistake has been committed. *United States v. United States Gypsum Co.*, 333 U.S. 364, 395, 68 S. Ct. 525, 542, 92 L. Ed. 746 (1948); *Dunbar Medical Systems*, 216 F.3d at 453.

III. Statutory Framework

I.R.C. § 7431(a) creates a right of action against the United States if a federal employee or official knowingly or negligently violates the confidentiality provisions of § 6103. Section 6103 states in relevant part:

Returns and return information shall be confidential, and except as authorized by [the Internal

Revenue Code], no officer or employee of the United States . . . shall disclose any return or return information obtained by him in any manner in connection with his service as such an officer or an employee or otherwise under the provisions of this section.

I.R.C. § 6103(a). "Return information" is defined broadly, to include in relevant part, "a taxpayer's identity . . . [and] whether the taxpayer's return was, is being, or will be examined or subject to investigation . . . ."

I.R.C. § 6103(b)(2)(A). The United States concedes that Batista disclosed "return information." The United States does not incur liability for a violation of § 6103, however, if the violation "results from a good faith, but erroneous, interpretation of section 6103." I.R.C. § 7431(b). In the case of a finding of liability, I.R.C. § 7431(c) provides for the award of statutory or actual damages, punitive damages, and attorneys fees.

I.R.C. § 6103(k)(6) creates a safe harbor for IRS agents carrying out certain investigative duties, and allows for disclosures as follows:

An internal revenue officer or employee may, in

> connection with his official duties relating to any . . . criminal tax investigation . . . disclose return information to the extent that such disclosure is necessary in obtaining information, which is not otherwise reasonably available, with respect to the correct determination of tax, liability for tax, or the amount to be collected or with respect to the enforcement of any other provision of this title. Such disclosures shall be made only in such situations and under such conditions as the Secretary may prescribe by regulation.

The Secretary has promulgated regulations pursuant to its authority.
See 26 C.F.R. § 301.6103(k)(6)-1(a)&(b).

As § 6103(k)(6) has been construed by case law, an IRS agent may disclose return information during an investigation in order to obtain information, provided three requirements are met: (1) the information sought is "with respect to the correct determination of tax, liability for tax, or the amount to be collected or with respect to the enforcement of any other provision of the [Internal Revenue Code]." (2) the information sought is "not otherwise reasonably

available"; and (3) it is "necessary to make disclosures of return information in order to obtain the additional information sought." *DiAndre v. United States*, 968 F.2d 1049, 1052 (10th Cir. 1992); see also *Barrett v. United States*, 795 F.2d 446, 449 (5th Cir. 1986)("*Barrett I*").

IV. Points of Error

The United States raises five points of error. It argues that:

1. The district court erred as a matter of law by concluding that Batista was obliged to consider Payne as a source from whom necessary information might be "otherwise reasonably available." According to the United States, the taxpayer under investigation is an inherently unreliable source of information, and thus is never a "reasonably available" source of information.

2. Even if the taxpayer might be a source from whom information is "otherwise reasonably available," the district court erred in finding that Payne was such a source here. Further, the district court erred in finding that the disclosures were not necessary to obtain the information sought.

3. If Batista did violate § 6103, the district court

erred in finding that Batista's violation was not the result of a "good faith, but erroneous, interpretation" of that section.

4. The district court erred in awarding punitive damages.

5. The district court erred in awarding and calculating attorneys fees.

Payne cross-appeals the district court's damage award, contending that he had provided sufficient evidence to sustain an award of $ 3.3 million in actual damages and $ 9.9 million in punitive damages.

V. The Taxpayer as "Reasonably Available" Source of Necessary Information

The United States argues that IRS special agents need never consider the taxpayer under investigation as a source from whom information is "reasonably available." Reviewing the statute and regulations promulgated under its authority, as well as the court decisions construing § 6103(k)(6), we find no convincing authority for this rigid proposition.

According to the regulations, disclosures are authorized only when the necessary information cannot be reasonably obtained in "accurate and sufficiently

probative form" or in a "timely manner," and "without impairing the proper performance of . . . official duties." 26 C.F.R. § 301.6103(k)(6)-1(a)&(b). Whether a disclosure is authorized depends upon the "facts and circumstances of the particular case." Id. Rather than foreclosing the possibility that the taxpayer could ever be a source from whom necessary information may "reasonably be obtained," the regulations reflect the fact-intensive nature of the inquiry.

While we find no previous case that addresses the precise argument made by the United States here, this court's decision in *Barrett* I implicitly considers the taxpayer a "reasonably available" source of necessary information. There, the court reversed a summary judgment in favor of the IRS, finding a fact issue as to whether certain third-party contacts were necessary. Noting evidence that the IRS had "free access" to the taxpayer's bank records, the court concluded that "some disclosures, perhaps all, might have been avoided by reviewing and analyzing [those] bank records." *Barrett I*, 795 F.2d at 450.

In *Kemlon Products & Development Co. v. United States*, 638 F.2d 1315 (5th Cir. 1981), modified on pet. for rehearing, 646 F.2d 223 (5th Cir. 1981), this

court reversed the granting of a permanent injunction prohibiting the IRS from disclosing the taxpayer's return information to its customers. The injunction was held to have violated the Anti-Injunction Act, 26 U.S.C. § 7421(a) (1999), because the taxpayer had not proved irreparable harm from the contacts. Id. at 1322. The court then suggested that even if irreparable harm had been established, in "all likelihood" the United States could defend a lawsuit on the basis of § 6103(k)(6). The underlying issue involved the value of certain patents, and the court noted the affidavit of the investigating agent that direct contact with the taxpayer's customers would be necessary to ensure candid responses. *Id.* at 1323. The tenor of this dicta indicated that the panel was evaluating the facts in that particular case and not endorsing an inflexible rule.[2]

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[2] In recent litigation, the United States has implicitly adopted the position that the subject of the investigation might be a reasonable source of information. See *Nowicki v. Comm'r of Internal Revenue*, 262 F.3d 1162 (11th Cir. 2001). There, the United States argued that the third-party contact was authorized by §6103(k)(6) because "information regarding the nature of the expenses . . . was 'not otherwise reasonably

The United States argues that it has the duty to corroborate a taxpayer's admissions and to investigate all reasonable leads to eliminate non-taxable deposits. See *Daniel Smith v. United States*, 348 U.S. 147, 154, 75 S. Ct. 194, 198, 99 L. Ed. 192 (1954); *United States v. Hiett*, 581 F.2d 1199, 1201-1202 (5th Cir. 1978); *United States v. Boulet*, 577 F.2d 1165, 1168 (5th Cir. 1978). Both of these tasks, the United States asserts, may only be accomplished through third-party contacts. To the extent that necessary evidence, corroborating or otherwise, is not reasonably available from sources provided by the taxpayer, § 6103(k)(6) obviously authorizes third-party contacts. However, even corroborating evidence might be available from bank or other records to which a taxpayer voluntarily grants access, thus negating the necessity of contacting third-parties. At any rate, in this case Batista was not merely corroborating information previously provided by Payne. Further, we find no contradiction between

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available' because [the taxpayer] disclaimed any knowledge of the nature of the expenses . . . ." *Id.* at 1163 (emphasis added). Such an argument connotes that the taxpayer is not inevitably an inherently unreliable source for obtaining necessary information.

the need to eliminate nontaxable sources of income while still considering the taxpayer an "available source" of information, because "in the typical case, the taxpayer gives the IRS 'leads' to possible nontaxable sources." *Hiett*, 581 F.2d at 1201; see also *Boulet*, 577 F.2d at 1169.

We do not hold that the taxpayer is always such a fruitful and reliable source of information that IRS agents may never approach third-parties for necessary information. We hold only that such a determination must be made in light of the "facts and circumstances of the case," and that the taxpayer's cooperation legitimately forms part of the inquiry.

VI. Necessity for Third-Party Contacts

The United States attacks the district court finding that, on the facts and circumstances of this case, Payne was a "reasonably available" source of information and that the disclosures were unnecessary in order to obtain the information sought. The district court found that Payne's efforts to cooperate were sincere and made in good faith, and that Batista in contrast made little or no effort to use this cooperation to advance his investigation. The court then made a

blanket finding of no evidence that any disclosure of Payne's return information was necessary. We must evaluate this finding, however, only to the extent that it led to any damages to Payne. In *Barrett v. United States*, 100 F.3d 35 (5th Cir. 1996)("*Barrett III*"), this court explained that the type of damages which must be proved by the taxpayer depends on the nature of the violation by the IRS. Thus, if the violation is simply an unnecessary third-party contact, an attorney-taxpayer such as Payne would have to prove that he lost business because of his clients' concerns over privacy issues. On the other hand, a violation occasioned by disclosure of the criminal nature of the investigation requires proof that Payne lost business because his clients thought him to be a "tax cheat." *Id.* at 39. It is clear from the district court opinion and the record that Payne's proof of damages was of the latter type. Accordingly, we focus on the finding that Batista regularly revealed the criminal nature of his investigation of Payne when making third-party contacts, since Payne's damages can only be sustained on the basis of these disclosures.

This court has previously held that it was unnecessary for an IRS agent to disclose the criminal

nature of an investigation when sending circular letters to the public requesting information regarding the taxpayer. See *Barrett v. United States*, 51 F.3d 475, 479 (1995)("*Barrett II*"). Applying this standard, the district court here found that Batista's disclosure of the criminal nature of his investigation was not necessary to obtain the information sought. The district court specifically found that "Batista issued a large number of administrative summonses and letters to third-parties which disclosed on their face that Payne was under criminal investigation." 91 F. Supp. 2d at 1025. While the partial dissent considers this finding to be clearly erroneous, it is not directly challenged by the United States in this appeal. Instead, the United States argues that "the circular letter cases do not apply to live, face-to-face interviews." As discussed infra, ultimate resolution of this issue will require further factual findings.

VII. Good Faith Erroneous Interpretation of Law

The United States argues that even if Batista made unauthorized disclosures, he did so pursuant to a good faith, but erroneous, interpretation of § 6103. In connection with a § 7431 violation, this circuit

evaluates "good faith" under an objective standard. See *Huckaby v. United States Dept. of Treasury, I.R.S.*, 794 F.2d 1041, 1048 (5th Cir. 1986); *Barrett II* 51 F.3d at 479. "A reasonable IRS agent can be expected to know statutory provisions governing disclosure, as interpreted and reflected in IRS regulations and manuals. An agent's contrary interpretation is not in good faith." Id. Applying this test, the district court found that "a reasonable IRS agent would not have violated the express provisions contained in Sections 6103 and 7431 and in the IRS manuals and regulations." *Payne,* 91 F. Supp. 2d at 1026. The district court further explained that "Batista initially claimed that although he was familiar with the statutes and the IRS regulations he was not required to try and obtain the needed information from the taxpayer first before with third-parties. Batista eventually admitted that he had violated express provisions regarding disclosure." *Id.* Accordingly, the court found that Batista's disclosures were not made in good faith.

Following the district court's decision, we had occasion to examine the application of the *Huckaby* standard. In *Gandy v. United States*, 234 F.3d 281 (5th

Cir. 2000), we held that two IRS agents who had disclosed return information (the taxpayer's identity and the fact of criminal investigation) to customers of a nursery had acted in good faith. The disclosures at issue were oral, made to customers the agents interviewed following distribution of a circular letter. We noted that Section 347.2 of the IRS Handbook, at least prior to 1992 changes, regulated the format and content of circular letters but did not apply "across the board to all disclosures, including oral disclosures." *Id.* at 286. We then noted Treasury Regulations allowing an IRS agent to disclose the nature of his official duties when investigating a taxpayer, as well as a Handbook provision authorizing display of credentials and badges identifying Criminal Investigation Division agents. We thus concluded that the IRS agents had a good faith belief that they could disclose the criminal nature of their investigation. *Id.* at 286-87.

The district court did not have the benefit of *Gandy* when it concluded that Batista did not have a good faith belief that he could disclose the fact of a criminal investigation. Also, as noted in *Gandy*, the section of the Handbook pertinent to that decision was amended in 1992. Furthermore, the district court's

finding of bad faith appears to be based on the premise that all third-party contacts by Batista were not authorized. However, as we previously indicated, Payne's evidence of damages was based primarily on the disclosures of the criminal nature of the investigation. The number of third-parties contacted and disclosures made in this case is voluminous. Batista discussed the investigation with third-parties via in-person interviews, telephone calls, letters, and summonses. The holding that Batista lacked good faith is not tied to particularized findings as to precisely what information about a criminal investigation was disclosed to which parties and under which circumstances. Determining which of these disclosures were necessary and reconciliation with *Gandy* will therefore entail further factfinding by the district court.[2]

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[2] We have no quarrel with the proposition that the good-faith analysis under § 7431 should follow the approach described in *Siegert v. Gilley*, 500 U.S. 226, 232, 111 S.Ct. 1789, 114 L.Ed.2d 277 (1991) for civil rights cases. That is, the district court should determine whether an error has actually been committed before considering whether the agent acted in good faith. Since we are asking the district court to make more

VIII. Conclusion

This case is remanded for proceedings not inconsistent with this opinion. Payne's cross-appeal for increased actual and punitive damages is dismissed as premature.

REVERSED AND REMANDED

CONCUR BY: EMILIO M. GARZA (In Part)

DISSENT BY: EMILIO M. GARZA (In Part)

DISSENT:

EMILIO M. GARZA, Circuit Judge, specially concurring in part and dissenting in part:

I concur generally in parts I - V and VII - VIII of the majority's opinion, but respectfully dissent from part VI. I would hold (a) that Payne was not a reasonably available source for at least some of the

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specific fact findings in this case, we think this issue can be clarified at that time.

information sought by the IRS in this case, and (b) that it is always "necessary" for IRS Special Agents to identify themselves as members of the Criminal Investigative Division when conducting in-person third-party interviews.

I.

I agree with the majority that the taxpayer under investigation might sometimes be an "otherwise reasonably available" source for at least some information sought by the IRS. The taxpayer might be able to provide exculpatory documents with independent indicia of reliability, such as bank records, cancelled checks, notarized copies of contracts, deeds, or credit card receipts that can help show that he has not committed a crime. These documents might alleviate the need for the IRS to contact at least some third parties in determining that a taxpayer has not cheated on his taxes.[1]

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[1] We have no quarrel with the proposition that the good-faith analysis under § 7431 should follow the approach described in *Siegert v. Gilley*, 500 U.S. 226, 232, 111 S.Ct. 1789, 114 L.Ed.2d 277 (1991) for civil rights cases. That is, the district court should determine whether an error has actually been committed before considering whether the agent acted in good

But I do not agree that Payne was a reasonably available source of information for all of the information sought by the IRS here. The majority overlooks this issue: it devotes much attention to the general question of whether taxpayers can ever be reasonably available sources of information, but little to the facts of this case. The majority's only analysis of this issue consists in a citation to a supposed factual finding by the district court that Payne was a reasonably available source for the information sought. In fact, the district court made no such finding. Although the tenor of the district court's opinion might in places imply that Payne was a reasonably available source of information, the court made no explicit finding to that effect.[2]

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faith. Since we are asking the district court to make more specific fact findings in this case, we think this issue can be clarified at that time.

[2] For example, the district court found that Batista contacted third parties "without first determining whether the information was otherwise reasonably available" and that the disclosures to third parties were not necessary in light of the fact that "the information repeatedly offered by Payne was ultimately delivered to . . . the United States Department of Justice." Of course, finding that Batista made no effort to

As the majority itself describes the requirements of suits based on 26 U.S.C. § 6103(k)(6), three inquiries are involved: (1) whether the information sought is related to enforcing the tax code, (2) whether the information was not "otherwise reasonably available," and (3) whether the disclosure of return information was "necessary" in order to obtain the information sought. No one disputes that the first criterion is satisfied here. The district court and the majority both seem to skip over the second step, and proceed directly to a determination of "necessity."

The questions of whether the information was "otherwise reasonably available" and whether the disclosures were "necessary" are "interdependent." *Barrett v. United States*, 795 F.2d 446, 449 (1986) (hereinafter "Barrett I"). We are concerned in this case with the necessity of three types of disclosures by the

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determine whether the information was reasonably available from Payne is not the same thing as finding that the information was in fact available from Payne. And the district court did not make any findings as to the content of the information eventually delivered to the Department of Justice and whether this information was the same or different from that sought by Batista from third parties.

IRS: the disclosure of the identity of the taxpayer, the disclosure that the taxpayer is under some kind of investigation, and the disclosure that the investigation into the taxpayer is criminal in nature. It is not possible to identify which of these three types of disclosures by Batista were "necessary" without determining what information was "reasonably available" from Payne. If Payne was not a reasonably available source of some information, then it was okay for Batista to try to get that information from other sources. If it was lawful for Batista to contact third parties, it was also by that fact necessary for him to disclose two kinds of return information: the identity of the taxpayer (Payne) and the fact that the taxpayer was under investigation. Batista could not solicit information about Payne without identifying him. And the very fact that the IRS is asking questions about someone will tip off the third party that the taxpayer is under some kind of investigation. Therefore, if Payne was not a reasonably available source of information, then the only unnecessary disclosure by Batista would be (in the majority's view) the disclosure that the investigation was *criminal* in nature.

But if Payne was a reasonably available source

of information, then all of the disclosures were unnecessary: the identity of the taxpayer, the fact of an investigation, and the fact that the investigation was criminal. If Payne was a reasonably available source of information, then Batista could have avoided all of the disclosures to third parties by securing the information from Payne himself.

In *Barrett v. United States*, 100 F.3d 35, 39 - 41 (1996) (*Barrett III*), we explained that the IRS is liable only for the damages occasioned by *unlawful* disclosures if some disclosures were permitted, and others not, then the IRS has to pay damages only for the disclosures that were not permitted. *Id.* at 40. In *Barrett III*, the IRS had mailed a number of circular letters to patients seeking information about a plastic surgeon. We explained that, because the information sought was not reasonably available from the doctor, there was nothing wrong with the mere fact that the IRS sent the circular letters. That is, because the information was not reasonably available from the taxpayer, it was not unlawful for the IRS to disclose the identity of the taxpayer and the fact that he was under some kind of investigation. The only unlawful disclosure was the statement in the body of the letter

that the taxpayer was under *criminal* investigation. *Id.* at 40 n.6. The doctor was thus required to show that his damages were caused not by the lawful disclosure of his identity and the fact of the investigation but by the unlawful disclosure of the criminal nature of the investigation. *Id.* at 39-40. If the doctor's medical practice was damaged because patients were worried about their privacy, about the fact of their having had plastic surgery becoming public during an investigation, then the damage would have been done just as effectively by the permitted disclosure that the doctor was under some kind of investigation as the impermissible one that the investigation was criminal. We therefore required the doctor to show that the patients were worried about the criminality of his behavior, not just their loss of privacy.

The same analysis applies here: it matters whether Payne was a reasonably available source of information so that we can correctly determine for which disclosures the IRS is liable. Under *Barrett III*, if Payne was a reasonably available source of the information sought, the IRS is liable for all of the damages Payne suffered as a result of the third party contacts. If Payne was not a reasonably available

source of information, the IRS is liable only for so much of Payne's damages as can be attributed to the disclosure that the investigation was criminal in nature. If the IRS's disclosure that Payne was under criminal investigation resulted in no more damages than the lawful disclosure that Payne was under some kind of investigation, the IRS is not liable for any of Payne's damages. It is therefore necessary to evaluate whether Payne was a reasonably available source of the information sought by Batista.

The majority's opinion may be internally contradictory on this point. It seems to leave undisturbed a supposed finding by the district court that Payne was a reasonably available source of the information sought. But it then cites the analysis from *Barrett III* explained in the preceding paragraphs, and proceeds as if the only issue is the damages caused by revealing the criminal nature of the investigation: "we focus on the finding that Batista regularly revealed the *criminal nature* of his investigation of Payne when making third-party contacts" (emphasis in original). If none of the contacts were permissible at all, it does not matter whether the damages were caused by the clients' concerns over privacy or over whether Payne

was a tax cheat: any damage from the third-party contact is redressable.

Even assuming for the sake of argument that the district court opinion can be read as finding that Payne was a reasonably available source for all of the information sought, then this conclusion would be clearly erroneous with respect to at least some of the information. Admittedly, for some of the information, Payne might have been an otherwise reasonably available source. For example, Batista contacted the Texas Lawyers Insurance Exchange to find out about $36 in interest income reported by Payne. Batista apparently admitted on the stand that he could have gotten this information (presumably in a sufficiently probative form) from Payne himself. Batista also contacted one of Payne's clients named Neal Talmadge. The sole information sought from this contact was apparently to confirm that Talmadge was a client of Payne, even though Batista had already confirmed that fact from court records. In these situations, the information sought by Batista might very well have been otherwise available without contacting third parties and without disclosing any return information.

But for other types of information sought by

Batista, Payne clearly was not an available source of the information. For example, Batista asked a number of people about Payne's involvement with drug sales.[3]

Payne obviously could not have provided sufficiently probative information about his own

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[3] The district court apparently believed that any disclosure designed to obtain information about Payne's involvement with drugs was not "necessary," regardless of whether the information was otherwise reasonably available, because Batista had "no rational basis" for thinking that Batista had sold illegal drugs. Our precedents preclude this line of reasoning. In *Barrett I* we explained that, in an action under § 7431 and 6103, we "do not question the right, wisdom, or necessity of a particular IRS investigation." *Barrett I*, 795 F.2d at 451. The question posed by the statute is not whether the information sought is necessary, but whether the disclosures were necessary to obtain the information sought. *Id.* As long as the information relates to enforcing the tax laws, the IRS can investigate any crime and look for any information it so desires. If the IRS wanted to investigate Payne for unreported income from drug sales, then § 6103 poses no bar to its doing so, regardless of whether the IRS had a "rational basis," "probable cause," "articulable suspicion," or any other justification for its investigation. *DiAndre v. United States*, 968 F.2d 1049, 1053 (10th Cir. 1992) ("Section 6103 does not provide a vehicle to test the probable cause or any other level of justification to investigate.").

involvement in illegal drug transactions. So I would find that Payne was not a reasonably available source for all of the information sought by Batista, and any district court finding to the contrary is clearly erroneous.

The district court did not make specific findings as to what information sought from third parties was reasonably available from Payne. These findings are necessary to a correct determination of the case, and I would remand to the district court for it to make these determinations in the first instance.

II.

Assuming that Payne was not a reasonably available source for at least some of the information sought by Batista, the next issue is whether it was "necessary" for Batista to disclose during third-party interviews that he was a criminal investigator. Batista's identification badge states, in large type, "Criminal Investigative Division;" Batista identified himself as a criminal investigator when talking to some potential witnesses; and Batista sometimes told third parties that he was conducting a criminal investigation of Payne. In *Barrett v. United States*, 51

F.3d 475, 478 (1995) (*Barrett II*), we held that the IRS needed to produce *trial evidence* of the necessity of disclosing the criminal nature of an investigation in the body of a circular letter. In the absence of evidence to the contrary, the district court was obligated to find that the disclosure was not necessary. *Barrett III* concerned *written* disclosures in a circular letter, not oral disclosures in the course of an in-person interview, as are at issue here. The majority nevertheless feels that *Barrett II* controls and that the IRS was obliged to present trial evidence of the necessity of Batista's disclosures. I disagree.

We interpret statutes according to the plain meaning of the words used. *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 242 (1989). There are two senses in which the word "necessary" is commonly used. "Necessary" sometimes means "strictly essential," or an indispensable precondition for the happening of an event. "Necessary" also sometimes means "appropriate or helpful." *Cf., e.g., McCulloch v. Maryland*, 17 U.S. 316, 414 (1819) (interpreting "necessary" in the Constitution's Necessary and Proper Clause to mean the latter of these two definitions, appropriate or helpful).

The first of these definitions has a strictly empirical character: if there is empirically any possible way that an event can happen without the occurrence of the condition, the condition is not necessary. The second of these definitions has both empirical and non-empirical elements. Empirically, we want to know whether or not something is "helpful." For example, are people really more likely to be cooperative or forthcoming in responding to a circular letter if the letter discloses the criminal nature of an investigation? Is the disclosure really "helpful" in getting meaningful replies? But there is also an element of this definition of necessary that looks to custom and usage: is the disclosure "appropriate" according to customary standards for handling such situations?

"Necessary" in § 6103 must mean the latter definition"appropriate or helpful" not "strictly essential." In legal contexts, we rarely use "necessary" in the latter sense. *See, e.g., Comm'r v. Heininger*, 320 U.S. 467, 471 (referring to the "commonly accepted meaning" of "necessary" as "appropriate and helpful"). If we were to interpret "necessary" to mean "strictly essential," the statute would be completely unworkable. If this were what were meant by

"necessary" in the statute, the IRS could never show that a disclosure was necessary. All that the plaintiff would have to show is that there was some possible way – however infeasible, however impractical, and however otherwise difficult – that could have induced the witness's cooperation without the disclosure.

Congress could not have intended to set such a high barrier. Section 6103 sets up a general rule that return information should be kept confidential. But it then sets out specific circumstances under which return information can be revealed during an investigation. It would not have made sense to have a section creating an exception from the confidentiality rules if the standard for disclosure were so high the exception could never be used. If Congress had intended to prevent the IRS from ever disclosing return information, even during investigations, it just would have left the confidentiality rule in place and not created any exceptions.

Taking "necessary" in the statute to mean "appropriate or helpful," *Barrett II* does not foreclose us from holding that it is necessary for an agent to identify himself truthfully as a criminal investigator when contacting third parties. *Barrett II* focused on the

empirical aspects of the word "necessary": whether it really, factually, empirically produces more helpful and forthright responses to have a circular letter say that the investigation is criminal than not. There is no way to answer this question meaningfully without empirical evidence: the testimony of experienced officers, results from various circular letters that both did and did not include the disclosure, and so forth. In the absence of such evidence, the *Barrett II* court was not prepared to conclude that the disclosure was necessary. Significantly, for circular letters, the other aspect of the word "necessary," the non-empirical aspect that focuses on custom and usage, is not really applicable. There are not any well-developed customs for how the police should solicit information from people in letters.

When it comes to in-person interviews by the police, however, the non-empirical aspect of the word "necessary" becomes very important: we are now concerned not only with whether such disclosures are "helpful" but also with whether they are "appropriate." There is a strong expectation that when a police officer shows up at your door to ask you questions that he identify himself, state the agency for which he works,

and show his identification. *Cf. Wilson v. Arkansas*, 514 U.S. 927 (1995) (detailing the common law tradition of requiring the police to identify themselves and "signify the cause of [their] coming" before entering a private dwelling, and incorporating this tradition into the Fourth Amendment inquiry into the "reasonableness" of a search). A regular and commonly expected part of the procedure of being approached by the police is the showing of identification. We do not need "evidence" to help us conclude that it is appropriate for IRS Special Agents to identify themselves and show their badges when conducting interviews: unlike *Barrett II*, the issue is not solely empirical here, it also concerns the customs and usages of the community. *Cf. Dickerson v. United States*, 530 U.S. 428, 443 (2000) (giving importance to the place of Miranda warnings in custom and social expectation, and noting "Miranda has become embedded in routine police practice to the point where the warnings have become part of our national culture"). In passing §§ 6103, Congress could not have intended to prevent IRS agents from complying with the widespread expectation that law enforcement agents show their badges and otherwise identify themselves to the people

whom they interview.

For circular letters, there was not any relevant custom or usage, so the question of whether the disclosure was necessary was solely an empirical question. Trial evidence of necessity was therefore required. Here, there is a relevant custom, so it is not solely an empirical question. Given social expectations about police identifying themselves, I do not think that empirical evidence would be helpful in ascertaining whether it is appropriate for Special Agents to show their badges or otherwise identify themselves when conducting third party interviews. *Barrett II* is therefore distinguishable, and we should conclude that it is necessary, in the sense of appropriate, for the tax police to identify themselves when approaching third parties about a tax investigation.

The district court and the majority also premise the IRS's liability in part on alleged *written* disclosures made in summonses and letters of the criminal nature of the investigation. The district court found that "Batista issued a large number of administrative summonses and letters to third-parties which disclosed on their face that Payne was under criminal investigation by the IRS." If Batista had disclosed the

criminal nature of the investigation in body of letters or summonses, then *Barrett II* would control, and the IRS would be liable for those disclosures in the absence of trial evidence of their necessity.

But I would find that this factual finding by the district court was clearly erroneous. Batista's letters and summonses are part of the exhibits in the record. These documents do not, in fact, disclose on their face the criminal nature of the investigation. All of the litigants seem to argue as if, and the majority reasons as if, the only issue is the necessity of Batista's oral disclosures, in apparent recognition of the fact that the written documents do not contain any disclosure of the criminal nature of the investigation. To the extent that the district court premised liability on the written documents, I would reverse.[4]

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[4] Batista used a standard IRS form for the summonses. The body of the summons states:

> *You are hereby summoned and required to appear before David Batista or his designee[,] an officer of the Internal Revenue Service, to give testimony and to bring with you and to produce for examination the following books, records, papers, and other data relating to the tax liability or the collection of tax*

III

I agree with the majority that we should remand for the district court to re-evaluate the good faith issue in light of *Gandy v. United States*, 234 F.3d 281 (5th Cir. 2000).[5] I also agree that we should

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liability or for the purpose of inquiring into any offense connected with the administration or enforcement of the internal revenue laws concerning the person identified above for the periods shown.

This statement does not disclose what kind of investigation the IRS is conducting. The summonses were sometimes accompanied by attachments, listing the documents sought, which also did not disclose the criminal nature of the investigation. Batista's letters sometimes stated that he was conducting an investigation of Payne, but they did not state that the investigation was criminal.

[5] I note one way in which our approach to this case differs from the approach taken by the *Gandy* court: we decide the question of whether Batista's oral disclosures of the criminal nature of the investigation were "necessary" before moving on to any discussion or consideration of whether the disclosures were in good faith. *Gandy*, like this case, concerned oral disclosures by IRS agents of the criminal nature of an investigation. The *Gandy* court decided the good faith issue first, and thereby avoided the issue of whether the disclosures were necessary. It reasoned that "we need not decide the difficult legal question of

whether agents McPherson and Sander's oral disclosures that *Gandy* was under criminal investigation were necessary if . . . [they were acting] in good faith." *Id.* at 285. The *Gandy* court did not consider it necessary to evaluate the "necessity" of the disclosures before evaluating the good faith of the agents.

The *Gandy* court's approach misunderstands the nature of the good faith defense. We have explained that the good faith defense resembles in many respects the qualified immunity for executive officials described in *Harlow v. Fitzgerald*, 457 U.S. 800, 73 L. Ed. 2d 396, 102 S. Ct. 2727 (1982). See *Huckaby v. United States*, 794 F.2d 1041, 1048 (5th Cir. 1986) ("The good-faith [sic] defense in section 7431(b) should be judged by an objective standard analogous to that employed in *Harlow*."); *Gandy*, 234 F.3d at 285. In *Harlow*, the Supreme Court explained that judges applying the qualified immunity test should first determine "the currently applicable law" and only then determine "whether the law was clearly established at the time an action occurred." *Harlow*, 457 U.S. at 818. The reason for this sequence is that we do not want to allow executive officials to violate the law indefinitely. We do not punish officials who make close and difficult, but wrong, decisions about the legality of their decisions. But, the first time a lawsuit is brought challenging a particular kind of official conduct, the courts are supposed to clarify the applicable state of the law so that officials do not make the same mistake in the future. The *Harlow* court therefore required that judges determine the "currently applicable law" before determining whether the law

dismiss Payne's cross-appeal, challenging the district court's award of damages, as premature.

The majority does not make clear that the IRS, like Payne, may also raise its challenges to the district court's damages and attorneys' fees awards in a subsequent appeal, if a subsequent appeal proves necessary. The IRS argues that Payne did not present sufficient evidence of causation of actual damages and that the district court awarded punitive damages for actions that were not disclosures and were not

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was "clearly established" at the time of the violations. *Id.* The same reasoning would seem to apply under § 7431: courts should first determine whether the IRS agents acted lawfully, and only then whether they acted in good faith.

The statute clearly contemplates that courts should follow this sequence. It permits a defense only for actions relying on "good faith, but erroneous" interpretations of applicable law. There is no way to know whether an officer's interpretation was "erroneous" without evaluating the current state of law. Although I joined in the opinion in *Gandy*, I acknowledge that our approach in that case was mistaken. In the future, I would have district courts and panels follow the lead set by the majority here -- evaluating first the actual state of the law, and then any good faith defense -- rather than the approach followed in *Gandy*.

unlawful. The IRS also argues that its litigating position was "substantially justified," which would preclude the district court's award of attorneys' fees. If the district court finds that Batista acted in good faith, the IRS would not be liable for any damages, and we would not need to consider these issues. I assume that the majority omits mention of these claims by the IRS because the issues might be avoided by the district court's decision on remand. I do not read the majority opinion as precluding the IRS from raising these challenges in the future if they prove necessary. With that understanding, I concur in all of the majority's opinion but part VI.

APPENDIX E

Entered Mar. 19, 1999

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

JERRY S. PAYNE, ET AL.
versus
UNITED STATES OF AMERICA, ET AL.

CIVIL ACTION NO. H-93-1738

FINDINGS OF FACT AND CONCLUSIONS OF LAW

I. Background

In this suit Plaintiff Jerry S. Payne ("Payne") alleges that the United States is liable for unauthorized disclosures of his confidential tax return information made by Internal Revenue Agents ("IRS") agents David W. Batista ("Batista"), Kenneth Frelow ("Frelow"), and Cohn Levy ("Levy") in violation of

Section 6103 of the Internal Revenue Code. In particular, Payne claims that Batista, Frelow, and Levy "unnecessarily and indiscreetly contacted Payne's clients, relatives and other attorneys with which Payne has done business and . . . made wrongful and unauthorized disclosures of confidential 'return information' concerning Payne." (Fifth Amended Complaint, Instrument No.226, at 9). For this unlawful conduct, Payne seeks actual and punitive damages. The United States denies Payne's contention, arguing instead that their agents did not disclose Payne's confidential return information. In the alternative, the United States maintains that if any disclosures of Payne's return information were made by its agents, such disclosures were authorized by law, or made pursuant to a good faith, but erroneous interpretation of the law.

This case was tried on August 14, 1998. Based on the evidence presented at trial, the Court makes the following findings of fact and conclusions of law. Any finding of fact that is more appropriately characterized as a conclusion of law shall be so construed.

FINDINGS OF FACT

1. Payne obtained a Bachelor of Business administration from the University of Texas in Austin, Texas. Later, in 1996, Payne received his Juris Doctorate from the University of Texas School of law. Payne became licensed to practice law in 1966. Payne first worked as a lawyer for the city attorney's office of Houston, Texas. He then went into the private practice of law in Houston, Texas. He formed a law firm and practiced law from 1974 until 1982. In 1982, Payne left the practice of law and went into the real estate development and construction business in Austin, Texas. After the real estate market crashed, Payne returned to the practice of law in 1985. Payne formed the law firm of Payne & Associates.

2. There were four different law firms sharing the office space where Payne worked. Mr. Robert Shaddox ("Shaddox") was an attorney who worked with Payne from the spring of 1991 to 1996. Shaddox decided to work with Payne because Payne's practice appeared to be growing over the course of three or four years.

3. Payne wanted to work on larger, more complex cases and he had a good network of referrals that would allow him to secure these types of cases. For example, Senator Buster Brown was a client of Payne. Payne worked on cases that were referred to him by Senator Brown. In addition, Payne received referrals from Senator Kay Bailey Hutchison.

4. In September of 1991, Batista began his criminal investigation of Payne. Levy had already prepared an initial report and gathered preliminary information regarding the civil investigation of Payne. Levy had substantial contact with Payne. In particular, Levy made very detailed and specific requests to Payne for information regarding 2618, Inc. Batista used Levy's report and information to begin the criminal investigation of Payne.

5. On October 29, 1991, Batista made his initial contact with Payne by arriving at Payne's law office unannounced instead of scheduling an appointment with Payne's office. Batista admitted that he was not prohibited from calling persons who are under criminal investigation in advance. Batista brought Levy and Mr.

Hicks to his initial visit with Payne. Levy had been dealing with Payne since 1989.

6. At the initial visit, Batista produced a summons for 2618, Inc. records. Payne told Batista that he would provide Batista with everything that needed to know about himself, 2618, Inc., and Mr. Leo Kalantzakis, a former client of Payne and the former owner of 1628, Inc. Batista did not ask Payne for the bank records concerning his law firm or his law practice. Batista was satisfied with his initial contact with Payne.

7. From October of 1991 to July of 1992, Payne sent numerous letters to Batista asking him to clarify the issues for which Batista wanted information from Payne. Batista wrote a letter to Payne responding to his request. In that letter, Batista informed Payne that he was under investigation by the IRS, but Batista did not give Payne the specific issues for which Batista wanted documents.

8. On December 19,1991, Batista contacted the Texas Lawyers Insurance Exchange and informed Ms. Herbert about the IRS's criminal investigation of

Payne. Batista wanted to know about the $36.00 in interest income from the Texas Lawyers Insurance Exchange to Payne. As of this date, however, Batista still believed that Payne was sincere about providing the requested documents and records. Batista conceded that he could have gotten this information from Payne and recognized that his criminal investigation would not have been prejudiced by allowing Payne to provide this information. Batista also admitted that he violated Section 6103 of the Internal Revenue Code by first contacting the Texas Lawyers Insurance Exchange.

9. On January 16, 1992, Payne and Batista reached an agreement on how to disclose the 2618, Inc. records. Payne and Batista agreed to adhere to several guidelines. In particular, the IRS agreed to review the records on a year-to-year basis and inform Payne which records were needed for copying. Payne would then have copies of the requested items made.

10. On January 20, 1992, Payne sent Batista a letter asking him to allow Payne to respond to any specific questions that Batista may have concerning Payne's involvement with 2618, Inc. Payne also informed

Batista that he was not waiving his Fifth Amendment rights and that he would not discuss any element of Batista's investigation with him until Batista had more reasonably and fairly narrowed any issues concerning Payne.

11. After scheduling appointments and in accordance with the parties' January 16, 1992 agreement, Batista and Levy came to Payne's office and began to review the 2618, Inc. records and microfilm on January 21, 1992. Batista and Levy continued their review of the 2618, Inc. records at Payne's office on January 22, 1992.

12. As of January 21, 1992, Batista was still happy with Payne's performance, cooperation, and his efforts to produce records. Batista testified that during this period Payne's conduct did not suggest that he was insincere about his willingness to assist with the investigation.

13. On March 2, 1992, Batista and Group Manager Swayzine Fields ("Fields") met with Payne at Payne's office. During this meeting, Batista requested the work

papers for Payne's 1987 and 1988 personal tax returns. Payne stated that he would provide the work papers used for the preparation of his 1987 and 1988 personal tax returns during the month of March. This was the first and only documented request for Payne's personal tax records.

14. With the exception of work papers for Payne's 1987 and 1988 tax returns, Batista never asked Payne for other personal records. Payne later told Batista that he did not have any work papers for his 1987 and 1988 tax returns. Batista never asked Payne, in writing or orally, for any additional information regarding his personal tax returns. Later, the IRS concluded that criminal prosecution of Payne for 1988 tax liability was unwarranted.

15. On March 12, 1992, Batista interviewed Mr. Jim Duffus ("Duffus"), a Revenue Officer with the IRS. Batista knew that Payne had given Duffus all of the records regarding 2618, Inc. between January of 1988 and September of 1988.

16. Throughout March of 1992, Batista sent out 10

(ten) summons to various corporations and banks seeking bank statements, canceled checks, deposit slips and deposited items, loan applications/agreements and related records concerning Payne.

17. Batista also contacted several additional third-parties during March of 1992. For example, Batista contacted Sarah Bilbo ("Bilbo"), the former bookkeeper for 2618, Inc. Batista asked Bilbo whether she knew if Payne was selling drugs. Batista also disclosed Payne's return information to Jeff Messock ("Messock"). Batista mistakenly left a summons for Arnoldus M. Hoegen-Dijkhof at Messock's home. Dijkhof purchased an automobile from Payne and Batista wanted information from Dijkhof regarding the sale of the car. Then, on March 30,1992, Batista and Ken Frelow ("Frelow") met with George Fountas ("Fountas"), a former shareholder of 2618, Inc. Batista and Frelow identified themselves as special agents with the IRS Criminal Investigation Division and presented their credentials for Fountas's inspection. Batista also disclosed Payne's return information to Terry Graz, a former client of Payne. In total, Batista made more than twenty-two (22) contacts with

third-parties during the month of March.

18. Later, on April 3, 1992, Batista, Levy, and Frelow had a meeting with Virginia Sutherland ("Sutherland"), Payne's former legal secretary, regarding the IRS's criminal investigation of Payne. The agents presented their credentials to Sutherland for inspection.

19. On May 28, 1992, Payne sent Batista a letter documenting the informal agreement reached by the parties on May 21, 1992. Payne and Batista agreed to the following:

> 1. Payne would not replead in his lawsuit against the IRS as required by Judge Hoyt;
> 2. Payne would file his 1989 and 1990 tax returns and provide Batista with copies. This would be done by Payne prior to July 27, 1992, which was heretofore the date of the parties' hearing before Judge Hoyt;
> 3. Batista would put a hold on seeking information as set out in his previous summonses until such time as he receives

Payne's tax returns. Upon examination of the 1989 and 1990 tax returns, Batista would give Payne information as to the areas in which Batista required more information; and

4. After Payne received Batista' s request in certain areas where he needed more information, Payne would promptly comply with said reasonable request.

20. Batista contacted Jim Schindler ("Schindler"), a real estate broker and a former client of Payne. Batista identified himself as being an agent with the criminal investigation division of the IRS and that he was conducting an investigation of Payne. Batista also informed Schindler that Payne may not have paid all of his taxes. Schindler decided that he would not use Payne's legal services again because of the outstanding criminal investigation by the IRS. He became aware of the investigation as a result of Batista's contact. Schindler also declined to refer any additional clients to Payne because of the criminal investigation.

21. When contacting witnesses, Batista introduced himself as a criminal investigator with the IRS. Batista

told these witnesses that he was investigating a possible violation of criminal revenue laws by Payne.

22. After the third-patty contacts made by Batista regarding the IRS's investigation of Payne, Shaddox noticed a change in the level of business activity in Payne's law office. Payne's law office no longer received the same volume of phone calls or potential new clients.

23. Shaddox became aware that Payne's clients and other third parties were being informed that Payne was under a criminal investigation. Mr. Guy Matthews, an attorney who shared office space with Payne's law firm, called Payne's office about being contacted by the IRS concerning an investigation of Payne.

24. On July 28, 1992, Batista contacted Mr. Neal Talmadge ("Talmadge"), a client of Payne and a corporate sales executive for the Houston Arrows Hockey Team, and informed Talmadge that Payne was under investigation. Batista contacted Talmadge to confirm that Talmadge was a client of Payne. Batista

also wanted to know if Talmadge would be willing to cooperate with the investigation. Batista had already gone to the Harris County courthouse to confirm that Talmadge had been represented by Payne.

25. Batista testified that he did not feel that he had any obligation to ask first Payne about his clients before contacting them. Batista insisted that the third party contact was a more reasonable and efficient way to get the information.

26. Talmadge was disturbed by the phone call from Batista. Talmadge would not have known about the criminal investigation of Payne if he had not received the phone call from the IRS or subsequently received information from Batista. Had Talmadge not known Payne before, Talmadge would have been reluctant to do business with Payne knowing that Payne was under criminal investigation. All of the employees at Talmadge's office knew that Payne was under criminal investigation. Some of these employees inquired about Payne's legal services. Talmadge told three or four employees about Payne's law practice and that Payne was under a criminal investigation by the IRS. As a

result, these employees had reservations about using Payne's legal services and did not contact Payne regarding their legal needs.

27. Batista issued several additional summons to former law clients of Payne requesting documents regarding any legal case in which Payne served as their legal representative. Batista also sent summons to other third-parties who transacted business with Payne or his law firm. In addition, Batista contacted people referred to Payne by Senator Brown and Senator Hutchison. For example, Batista contacted Dr. Simeon Wall in Louisiana.

28. Batista asked Connie Rema ("Rema"), Payne's former legal secretary and former client, whether she knew if Payne either used or sold drugs. Rema worked for Payne prior to 1985, before Payne owned Caligula XXI. Batista also asked other employees of Caligula XXI and other people who had business or personal relationships with Payne, such as Payne's brothers and relatives whether they knew if Payne used or sold drugs.

29. On August 26, 1992, Payne sent Batista a letter explaining his frustration with Batista's failure to adhere to their May 21, 1992 agreement. Several of Payne's clients told Payne that they had been contacted by Batista. Bankers, referral lawyers, and individuals from Senator Brown's office informed Payne that Batista told them that Payne was under criminal investigation. Payne informed Batista that his unnecessary contacts with third-parties was damaging his law practice.

30. The last disclosure of Payne's tax return information by Batista was made to Glenn Fogle in 1995; however, Payne is still asked by people whether he has resolved his situation with the IRS.

31. By August of 1996, Payne's law firm was not expanding or receiving new cases.

32. Payne and Payne and Associates, Inc. experienced a significant drop in gross receipts because of the unauthorized disclosures of tax return information made by Batista.

James Hill ("Hill") conducted a financial analysis of Payne's law firm. Hill prepared a best case, a worst case, and an average case scenario. He determined the overall lost profits to Payne's law practice and brought that figure back to the present value. There was a severe drop in gross receipts to Payne and Payne and Associates, Inc. between 1993 and 1994 after a steady growth rate for seven (7) to eight (8) years. Hill testified that some event caused this severe drop in gross receipts. However, Hill stated, a number of events could have caused the decline. Hill calculated the damage to Payne and Payne and Associates, Inc. at 3.3. million dollars based on the average case scenario and with Payne working through age seventy (70). Hill then recalculated the figures with the assumption that Payne would retire that the age of sixty (60). The damage amount still totaled 3.3 million dollars. Hill recalculated the damages to Payne and Payne and Associates, Inc. using a discount rate for 1994 through 1997.

34. There are several methods of proof that an agent may use to prove criminal tax liability, including the specific item method and the bank deposit method.

Although both methods permit an agent to corroborate admissions and evidence, neither method requires agents to first seek out third-parties. Furthermore, corroboration under either method of proof implies that the taxpayer is given an opportunity to provide the needed information first. Since Payne was not afforded such an opportunity, the type of method of proof used by Batista during the investigation is irrelevant to the discussion of whether there was an unauthorized disclosure of Payne's confidential tax return information.

35. The special agent should provide the taxpayer with a specific list of what he is seeking. The agent should always ask the taxpayer for records first regardless of the method of proof he intends to use. The method of proof that the agent decides to use is inconsequential if the taxpayer is willing to cooperate. If the taxpayer is not cooperating and the specific item method of proof is being used then the agent would need to contact witnesses. However, it is not necessary to go to every client of the taxpayer to corroborate canceled checks.

36. The special agent needs to work with the taxpayer to whatever degree is required to secure the needed records. It is not necessary to contact all of a taxpayer's customers or clients if the taxpayer is willing to provide the records himself. Moreover, if the taxpayer is willing to get the records from the bank or third-parties then the agent should give the taxpayer an opportunity to do that. Disclosures of confidential return information harm the reputation of the taxpayer.

37. In addition, it is not necessary for an agent to identify himself as a special agent with the criminal investigation division of the IRS. There is an implication of a criminal investigation when a special agent says that he is with the criminal investigation division and that the taxpayer is under investigation.

38. Batista acknowledged that, as a general rule, where the taxpayer is aware of the investigation and is cooperating, the special agent should obtain information directly from the taxpayer or the taxpayer's representative. Batista also recognized that the special agent should be discreet. The IRS

regulations are clear and unambiguous. Batista knows that he is required to follow these regulations. Batista is also charged with being familiar with the IRS agents handbooks. Batista received training on disclosure of confidential tax return information.

39. Regardless of the degree of Payne's cooperation, Batista would still have to get some information from his bank. For example, Batista would need to secure a copy of the signature cards. Batista acknowledged that he could have requested the documentary evidence from Payne; however, he did not ask Payne for such information.

40. Batista did not give Payne a fair opportunity to provide the records first before Batista contacted third-parties. Batista could have conserved the IRS's resources and allowed Payne to provide the information. Batista did not comply with IRS standards of conduct for special agents. It was not necessary for Batista to contact all of Payne's clients. Furthermore, he failed to use his best efforts to obtain the information voluntarily from the taxpayer. Moreover, Batista did not limit the effects of his

disclosures as required by IRS regulations, especially as it related to his suggestion of drug activity by Payne.

CONCLUSIONS OF LAW

1. Section 6103 of Title 26 "forbids the disclosure of return information." *Huckaby v. United States*, 794 F.2d 1041, 1046 (5th Cir. 1986) (citing 26 U.S.C. § 6103(a)); *Barrett v. United States*, 795 F.2d 446, 449 (5th Cir. 1986). In particular, Section 6103 states that:

> [r]eturn and return information shall be confidential, and except as authorized by this title . . . no officer or employee of the United States . . . *shall disclose any return or return information* obtained by him in any manner in connection with his service as such an officer or an employee or otherwise or under the provisions of this section.

26 U.S.C. § 6103(a) (emphasis added). Thus, as a general rule, returns and return information shall be confidential. *Barrett*, 795 F.2d at 449. "The need to minimize disclosures is particularly important when it

is remembered 'that our voluntary assessment system of tax action is in large measure dependent upon the realization of a taxpayer's expectation that the information required of him for this purpose would be kept confidential." *Diamond v. United States*, 944 F.2d 431, 434 (5th Cir. 1991) (quoting *Flippo v. United States*, 670 F. supp. 638, 642 (W.D.N.C. 1987) (emphasizing that Congress realized this fact when enacting Section 6103); see *Johnson v. Sawyer*, 640 F. Supp. 1126, 1132 (S.D. Tex. 1986) ("Congress enacted . . . [Section] 6103 to protect taxpayers' reasonable expectation that information submitted to the IRS would remain confidential.").

2. Section 6103(b) defines "return information" broadly, to include:

> a taxpayer's identity, the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessment, or tax payments, whether the taxpayer's return was, is being, or will be examined or subject to other

> investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense . . . .

26 U.S.C. § 6103(b)(2)(A); see *Barrett*, 795 F.2d at 449; *Johnson v. Sawyer*, 640 F. Supp. 1126, 1129 (S.D. Tex. 1986) (noting that the term "return information" is broad and encompasses "any information gathered by the IRS regarding a person's tax liability). Thus, "[r]eturn information includes the taxpayer's identity, the fact that the taxpayer is under investigation or subject to further investigation, and data that the IRS has collected about a return." *Huckaby*, 794 F.2d at 1046.

3. "The term 'disclosure' means the making known to any person in any manner whatever a return or return information." 26 U.S.C. § 6103(1,)(8). An agent cannot make a decision regarding the method of proof

without any regard to the limitations placed on his conduct by Section 6103.

4. The third-party contacts made by Batista through phone calls, letters, and summonses concerning the IRS's criminal investigation of Payne constitute disclosures of Payne's confidential return information. In particular, Batista's identifying himself as a member of the Criminal Investigation Division and informing third-parties that Payne was under a criminal investigation by the IRS disclosed return information about Payne. See *Diamond*, 944 F.2d at 434. Section 6103 expressly defines return information as "whether the taxpayer's return was, is being, or will be examined or subject to other investigation." 26 U.S.C. § 6103(b).

5. Section 6103 also includes several exceptions to this general prohibition on disclosure. In particular, Section 6103(k)(6) provides that:

> [a]n internal revenue officer of employee may, in connection with his official duties relating to any audit, collection activity, or civil or criminal tax

> investigation or any other offense under the internal revenue laws, disclose return information to the extent that *such disclosure is necessary* in obtaining information, which is *not otherwise reasonably available*, with respect to the correct determination of tax, liability for tax, or the amount to be collected or with respect to the enforcement of any other provision of this title. *Such disclosures shall be made only in such situations and under such conditions as the Secretary may prescribe by regulation.*

26 U.S.C.§ 6103(k)(6) (emphasis added). Thus, Section 6103(k)(6) allows an IRS officer or employee to disclose return information "to the extent that such disclosure is necessary in obtaining information, which is not otherwise reasonably available, with respect to the correct determination of tax, liability for tax, or the amount to be collected . . . ." 26 U.S.C. § 6103(k)(6); see *Barrett*, 795 F.2d at 449. However, such disclosure may only be made "in such situations and under such conditions" as the Secretary of the Treasury may prescribe. 26 U.S.C. § 6103(k)(6). The court does "not question the right, wisdom, or necessity of a particular

IRS investigation[,]" but does "question . . . the means of investigation, but only to the limited extent consistent with [S]ection 7431 of Title 26, which provides a civil cause of action for improper disclosures of return information. *Barrett*, 795 F. 2d at 451.

6. With respect to summonses, the Treasury Regulations state that:

> the Commissioner is authorized to summon the person liable for the tax or required to perform the act, or any officer or employee of such person or any person having possession, custody, or care of books of accounts containing entries relating to the business of the person liable for tax or required to perform the act, or any other person deemed proper, to appear before a designated officer or employee of the Internal Revenue service . . . and to give such testimony, under oath, as may be relevant or material to such inquiry; and take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry. This summons may be used in an investigation of

> either civil or criminal tax-related liability. The Commissioner may designate any employee of the Internal Revenue Service as the individual before whom a person summoned . . . shall appear. Any such employee, when so designated in the summons, is authorized to take testimony under oath of the person summoned and to receive and examine books, papers, records, or other data produced in compliance with the summons.

Treas. Reg. § 301.7602-1(b).

7. The Treasury Regulations also provide that, in connection with official duties, an officer or employee of the IRS may disclose taxpayer identity information, "the fact that the inquiry pertains to the performance of official duties, and the nature of the official duties in order to obtain necessary information relating to performance of such official duties[.]" Treas. Reg. § 301.6103(k)(6)-1(a). However, disclosure of taxpayer identity information to a person other than the taxpayer at issue should be made

> only if the necessary information cannot, under the facts and circumstances of the particular case, otherwise reasonably be obtained in accurate and sufficiently probative form, or in a timely manner, and without impairing the proper performance of the official duties, or if such activities cannot otherwise properly be accomplished without making such disclosure.

Id. An IRS officer or employee may also disclose return information in order to obtain necessary information relating to the following:

> (1) To establish or verify the correctness or completeness of any return . . . or return information;
>
> (2) To determine the responsibility for filing a return, for making a return where none has been made, or for performing such acts as may be required by law concerning such matters;
>
> (3) To establish or verify the liability (or possible liability) of any person, or the liability (or possible liability) at law or

equity of any transferee or fiduciary of any person, for any tax, penalty, interest, fine, forfeiture, or other imposition or offense under the internal revenue laws or the amount thereof to be collected;

(4) To establish or verify misconduct (or possible misconduct) or other activity proscribed by the internal revenue laws;

(5) To obtain the services of persons having special knowledge or technical skills or having recognized expertise in matters involving the valuation of property where relevant to proper performance of a duty or responsibility described in this paragraph;

(6) To establish or verify the financial status or condition and location of the taxpayer against whom collection activity is or may be directed, to locate assets in which the taxpayer has an interest, to ascertain the amount of any liability . . . to be collected, or otherwise to apply the provisions of the Code relating to establishment of liens against such assets, or levy on, or seizure,

or sale of, the assets to satisfy any such liability; or

(7) To prepare for any proceedings described in section 6103(h)(2) or conduct an investigation which may result in such a proceeding, or where necessary in order to accomplish any activity described in subparagraph (6) of this paragraph.

Treas. Reg. § 301.6103(k)(6)-1(b). Again, a disclosure of return information to someone other than the taxpayer being investigated should only be made if such information cannot otherwise be reasonably obtained. *Id.*

8. The IRS provides conduct guidelines for Special Agents during investigations as follows:

a. All returns and return information are confidential and may not be disclosed except as authorized by the Internal Revenue Code . . . [C]ivil actions for damages are permitted against the Government [unauthorized disclosures]

> . . . The fact that a person has filed a tax return or is under investigation is [return information] . . . . Disclosure is the making known of returns or return information in any manner. A disclosure may be either direct or indirect.

Internal Revenue Manual-Administration, Special Agents Handbook, ¶¶ 348.1-348.2.

b. Tactful – As professionals, special agents should always exercise good judgment. He/she should be tactful in all aspects pf the investigation so that actions and/or remarks are not likely to be misinterpreted.

Internal Revenue Manual – Administration, Investigative Procedures,¶ 9382.1(3).

c. Discreet – A special agent should be discreet in all investigations conducted. He/she must not make statements or ask questions that will divulge information which would tend to jeopardize the successful conclusion of the investigation.

He/she must not unnecessarily injure the reputation of the person being investigated.

Internal Revenue Manual – Administration, Investigative Procedures, ¶ 9382.1(4).

d. All criminal investigations should be started and concluded as expeditiously as possible. They should be conducted impartially and thoroughly to obtain all critical information and evidence. Duplication in investigations, unnecessary inconveniences to the public and unnecessary embarrassment to the taxpayer should be avoided. Appropriate courtesies should be shown when soliciting information.

Internal Revenue Manual-Administration, Policies of the IRS Handbook, ¶ P-9-29.

e. As a general rule, in instances when the taxpayer is aware of the investigation, is cooperating, an dis believed to have the needed information, special agents should

> obtain such information directly from the taxpayer or the taxpayer's representative unless to do so might tend to prejudice the investigation.

Internal Revenue Manual – Administration, Special Agents Handbook, ¶ 348.3.

f. A special agent should use his/her best efforts to obtain information voluntarily from taxpayers and witnesses.

Internal Revenue Manual – Administration, Special Agents Handbook, ¶ 363.

g. Detrimental effects to be avoided are:

> 1. unnecessary embarrassment to the principal.
>
> 2. needless disclosure of the Government's affairs or information of a confidential nature . . . . In any event, whenever the special agent first officially meets with the subject of the investigation, he/she should be

introduced as "Special agent, Internal Revenue Service," and will produce his/her credentials for examination.

Internal Revenue Manual – Administration, Special Agents Handbook, ¶¶ 3(10)8.1(5)(c), 3(10)8.1(7), 3(10)8.11(5)(c).

h. Mail circularization is a written request to third parties for information where more than ten letters of a similar nature are sent. Mail circularization to obtain third party evidence may be, under certain circumstances, the most practical means of obtaining documentary evidence in an investigation when a large number of persons, widely scattered geographically, need to be reached. If not judiciously used, mail circularization may result in unwarranted embarrassment to the taxpayer . . . . A special agent should exercise caution not to damages the reputation of the taxpayer by making the letter either offensive or suggestive of any wrongdoing by the taxpayer.

Internal Revenue Manual – Administration, Special Agents Handbook, ¶ ¶ 347.1, 347.2(3).

9. The fact that an agent has given prior "in court" testimony relative to the taxpayer's "return information," which likely removes this information from its otherwise "confidential" cloak, does not justify the agent's violation of the requirement that he, as an officer of the United States, is prohibited from disclosing "return information" absent express statutory authorization. *See Johnson v. Sawyer*, 120 F.3d 1307, 1318-19 (5th Cir. 1997); *Rodgers v. Hyatt*, 697 F.2d 899, 906 (l0th Cir. 1983); *Mallas v. United States*, 993 F.2d 1111, 1120 ("The Government points to no such exception-and we are aware of none-permitting the disclosure of 'return information' simply because it is otherwise available to the public."). Simply because "'an event is not wholly 'private' does not mean that an individual has no interest in limiting disclosure or dissemination of information.'" *Mallas*, 993 F.2d at 1120 (quoting *United States Dep't of Justice v. Reporters Comm. for Freedom of the Press*, 109 S. Ct. 1468, 1480 (1989)(citations omitted)); *see Johnson*, 120 F.3d at 1318-19.

10. Under Section 7431(a)(1) of Title 26, a taxpayer may bring a civil action for damages against the United States for knowing or negligent disclosure of returns or *return information* by United States employees. 26 U.S.C.§ 7431(a)(1). Section 7431(a)(1) states, in pertinent part, that "[i]f any officer or employee of the United States knowingly, or by reason of negligence, inspects or discloses any return or return information with respect to a taxpayer in violation of any provision of section 6103, such taxpayer may bring a civil action for damages against the United States in a district court of the United States." 26 U.S.C. § 7431(a)(1)(emphasis added). Thus, to obtain damages for wrongful disclosure under Section 7431(a)(1), a plaintiff must prove: (1) that a government employee knowingly or negligently disclosed confidential tax return information; and (2) that the disclosure was not authorized by Section 6103. *Wilkerson v. United States*, 67 F.3d 112, 115 (5th Cir. 1995).

11. Without first determining whether the information sought was otherwise reasonably available, Batista contacted a large number of Payne's clients, several of his business associates, friends,

relatives, and employees of state and local law enforcement agencies. Batista disclosed numerous items of return information to these persons. For example, on several occasions, when making these third-party contacts, Batista disclosed the fact that Payne was under criminal investigation by the IRS. Batista issued a large number of administrative summonses and letters to third-parties which disclosed on their face that Payne was under criminal investigation by the IRS. The United States "offered no evidence that disclosing the fact that a taxpayer was under investigation is necessary to obtain the information sought by sending the letters." *Barrett v. United States*, 51 F.3d 475, 478 (5th Cir. 1995); *cf Diamond*, 944 F.2d at 435 (holding that, as a matter of law, IRS agent did not need to identify himself in circular letters as a member of the Criminal Investigation Division to secure the desired information). Furthermore, there was no evidence that any of the disclosures of Payne's confidential return information, either through phone calls, letters or summonses, were necessary to obtain the information that Batista sought. Consequently, the Court holds that it was not necessary for Batista to disclose the

various items of return information to all of the third-parties that Batista contacted, especially since the information repeatedly offered by Payne and refused by Batista was ultimately delivered to Gregory Gallagher of the United States Department of Justice, Tax Division, Criminal Section. The Court further holds that such disclosures were made knowingly or by reason of negligence, and thus, were in violation of Section 6103.

12. Batista also asked numerous third-parties, including clients of Payne, questions about whether or not Payne used or was involved in illegal drugs. Batista contends that a witness allegedly told him that Payne was involved in drugs or other criminal activity, however, Batista could not remember the name of the witness or whether such information was obtained during a formal or informal interview. The Court finds that there was no rational basis for Batista to ask these questions particularly in light of IRS regulations that require special agents to avoid "unnecessarily injur[ing] the reputation of the person being investigated." Internal Revenue Manual – Administration, Investigative Procedures, ¶ 9382.1(4).

13. Recovery under Section 7431(a)(1) must be denied if the disclosure "results from a *good faith*, but erroneous interpretation of section 6103." 26 U.S.C. § 7431(b)(1) (emphasis added). The "good faith" exception protects the United States from liability where the alleged violation arises from a good-faith misunderstanding of Section 6103. See 26 U.S.C. § 7431(b)(1). In determining whether an agent has behaved in "good faith," the Fifth Circuit has adopted the following objective standard: officials act "in good faith when 'their conduct does not violate clearly established statutory or constitutional rights of which a reasonable person would have known.'" *Huckaby*, 794 F.2d at 1048 (quoting *Harlow v. Fitzgerald*, 102 S. Ct. 2727, 2738 (1982)). "A reasonable IRS agent can be expected to know the provisions of [S]ections 6103 and 7431, as they may be further clarified by IRS regulations and other IRS interpretations." *Huckaby*, 794 F.2d at 1049; *Heller v. Plave*, 657 F. Supp. 95, 98 (S.D. Fla. 1987). "An agent's contrary interpretation is not in good faith." *Barrett,* 51 F.3d at 479.

14. Applying an objective good-faith test to the facts of this case, leads to only one conclusion: that a

reasonable IRS agent would not have violated the express provisions contained in Sections 6103 and 7431 and in the IRS manuals and regulations. *See Barrett*, 51 F. 3d at 480. In fact, Batista initially claimed that although he was familiar with the statutes and IRS regulations he was not required to try and obtain the needed information from the taxpayer first before communicating with third-parties. Batista eventually admitted that he had violated express provisions regarding disclosure. Batista, therefore, did not act in good faith. *Cf Schachter v. United States*, 866 F.2d 1273, 1274-76 (N.D. Cal. 1994) (holding that the agent's disclosures were a good faith but erroneous interpretation of Section 6103 since "a reasonable special agent would not have known that he should not disclose the information at issue here" given the ambiguity in the statute itself and the fact that the applicable IRS manual recommended such conduct).

15. "This Court finds that such disclosures . . . depict a lack of integrity on the part of the government. Such careless conduct must be reprimanded. The responsibilities of the IRS are gravely important and should not be tainted by irresponsible comments."

Heller, 657 F. Supp. at 99. The government "must bear responsibility for improper disclosures. Section 6103 acts as a restraint on unsuitable behavior among IRS agents and mandates the protection of our government's rectitude." *Id.*

16. "Once liability attaches, a court must make determination of damages consonant with" Section 7431(c). *Barrett v. United States*, 100 F.3d 35, 38 (5th Cir. 1996). Section 7431 provides that:

> [i]n any action brought under subsection (a), upon a finding of liability on the part of the defendant, the defendant shall be liable to the plaintiff in an amount equal to the sum of –
> (1) the greater of –
> (A) *$1, 000 for each act of unauthorized inspection or disclosure* of a return or return information with respect to which such defendant is found liable, or
> (B) the sum of –
> (i) *the actual damages sustained by the plaintiff* as a result of such unauthorized inspection or

> disclosure, plus
>
> (ii) in the case of a willful inspection or disclosure or an inspection or disclosure which is the result of gross negligence, *punitive damages*, plus

(2) the costs of the action.

26 U.S.C. § 7431(c) (emphasis added). Specifically, Section 7431 "limits actual damages to those 'sustained . . . as a result of [an] unauthorized disclosure.'" *Barrett*, 100 F.3d at 40 (quoting 26 U.S.C.§ 7431(c)(1)(i)).

17. In *Barrett v. United States*, 917 F. Supp. 493, 495 (S.D. Tex. 1995), the court examined whether the plaintiff, a plastic surgeon, had proved that actual damages "were inflicted by the disclosure of the criminal investigation in circular letters" sent by the IRS. The plaintiff's position was that, "but for the circular letters, his [medical practice would have been more substantial. The patients of a plastic surgeon are particularly concerned that their privacy be maintained." *Id.* at 496. The plaintiff then argued that

"when 260 [of his] patients received this letter, they would have become angry with . . . [him] because their privacy had been breached[.]" *Id.* Furthermore, according to the plaintiff, "when the patients read that . . . [he] was under criminal investigation, they would have thought less of . . . [him] as a law abiding citizen." *Id.* Consequently, the plaintiff "maintained that both of these circumstances would render the patients disinclined to return to him for further plastic surgery and to recommend him to their friends." *Id.*

The court held that "the decrease in patients was [likely] a result of a combination of factors, the most unlikely of which, given the totality of evidence, was the disclosure in the IRS letter." *Id.* at 502. The court emphasized that "any actual damages must have arisen from the disclosure to the patients of the criminal investigation and not from the concern of the patients that their privacy had been breached." *Id.* In fact, the court found that there was no "evidence that any physician had, in fact, not referred patients [the plaintiff] because of the letters[.]" *Id.* at 496. The plaintiff, himself, admitted that he has never identified one patient who had refused, either as a result of the disclosures or out of privacy concerns, to see him or any

doctors that declined to refer patients to him. *Id.* at 499. Furthermore, "the testimony of the physicians among the witness all emphasized that . . . [the plaintiff] enjoyed an excellent reputation as a surgeon." *Id.* The Court then criticized the expert certified public accountant's "lost income model," his assumption of causation, and his failure to "differentiate the damage that he maintained was caused by the improper disclosure in the circular letters from the damage that the many other [identified] factors that could have contributed to the drop in the number" of the plaintiff's patients. *Id.* at 502. Given that only speculation connected the loss in patients to the unlawful disclosures, the court determined that the plaintiff had failed to prove that he suffered actual damages from the improper disclosures in the circular letters. *Id.* at 497-502.

18. Unlike the situation in *Barrett*, Payne presented evidence that the damage he sustained to his law practice and law firm was caused by the improper disclosures by Batista. Shaddox testified that there was a noticeable change in the level of business activity, including client referrals, in Payne's law firm

after the third-party contacts were made by Batista. In addition, Schindler, a former client of Payne who was contacted by Batista, indicated that he would not use Payne's legal services again or refer any additional clients to Payne because of the outstanding criminal investigation by the IRS. Talmadge, another client of Payne's who was contacted by Batista, stated that he would not have known about the criminal investigation of Payne if he had not received a phone call from Batista. When asked by co-workers about Payne's legal services, Talmadge informed them about the IRS investigation. Consequently, Talmadge's co-workers did not contact Payne.

Furthermore, Hill, Payne's expert witness, testified that there was a severe drop in gross receipts to Payne's law firm between 1993 and 1994 after a steady growth rate for seven (7) to eight (8) years. Although Hill did not attempt to conclusively establish the cause of this severe drop in gross receipts, the United States did not offer any additional theories for the loss that Payne suffered. *Cf Barrett*, 917 F. Supp. at 495 (noting the United States's opposition to the taxpayer's requested actual and punitive damages award and emphasis that it vigorously contested the

taxpayer's damage claims at trial on cross examination, namely, by offering additional theories of causation). In this case, there is more than mere speculation to support the conclusion that the decline in clients and client referrals was caused by the unauthorized disclosures made by Batista. The Court, therefore, determines that the United States is liable to Payne for actual damages in the amount of $1,536,680.00.

19. In addition to actual damages, Section 7431

> authorizes a punitive damage award only if the disclosures are willful or grossly negligent. Willful conduct is that which was done without ground for believing that it was lawful or conduct marked by a careless disregard of whether one has a right to act in such a manner. Conduct that is grossly negligent is that which is either willful or marked by wanton or reckless disregard of the rights of another.

Barrett, 100 F.3d at 40 (quotations omitted). "Congress directed that liability be found only upon a showing of

bad faith and punitive damages only upon a showing of willfulness or gross negligence." *Id.* at 41. "To resolve this question, [the Court's] . . . task is to determine whether the record would support a finding that [Batista . . . made the disclosures without ground for believing that they were lawful or with a reckless disregard" of Payne's rights. *Marre v. United States*, 38 F.3d 823, 826 (5th Cir. 1994). "Section 7431(c) precludes the award of punitive damages in a case in which actual damages have not been shown." *Barrett*, 917 F. Supp. at 504.

20. The conduct exhibited by Batista was so egregious as to warrant an award of punitive damages. For example, Batista testified that he never calls to make an appointment, but rather arrives at the taxpayer's location, his place of residence or business, unannounced. Batista, however, acknowledged that he was not prohibited from calling Payne in advance to schedule an appointment. Furthermore, Batista made devastating disclosures regarding Payne's suspected involvement in illegal drugs to Payne's clients, business associates, friends, and relatives. Batista, incredulously, maintained that asking third-parties

whether a person was a drug dealer would not hurt that person's reputation. In particular, Batista attempted to convince the Court that he sought to protect Payne's reputation by distinguishing between "asking" whether Payne was a drug dealer and "saying" that Payne was a drug dealer. According to Batista, a simple inquiry would not injure that person's reputation. The Court finds this testimony to be insincere and entirely reflective of Batista's cavalier attitude. As such it is relevant to the issue of punitive damages. Such a statement or inquiry by an officer of the United States would definitely ruin a person's reputation.

Moreover, as mentioned, under Section 6103, an IRS agent has discretion to disclose return information to the extent that the information is necessary and not otherwise reasonably available. 26 U.S.C. § 6103. Batista grossly abused that discretion. Batista made a number of third-party contacts without first giving Payne an opportunity to provide the needed information. Batista also initially insisted that there was no requirement that an agent obtain as much information as possible from the taxpayer before contacting third-parties. Later, Batista admitted that

his conduct violated the IRS manual and regulations. In addition, Batista had no rational explanation for his conclusion that Payne was not being sincere about his willingness to cooperate and his desire to assist Batista in the investigation. The facts and circumstances of this case call for an award of punitive damages under Section 7431(c)(1)(B)(ii). The disclosures made by Batista were done willfully or with gross negligence and the Court, therefore, holds that Payne is entitled to punitive damages in the amount of $1,000.00.

21. Payne's agitation with Batista's course of conduct is understandable. See *Diamond,* 944 F.2d at 434. "In our society, even without an actual conviction, the suggestion of criminal activity can transform and devastate an individual's life[.]" *Id.* In Payne's case, it destroyed the confidence of his clients in their lawyer and of others in a potential lawyer, leaving Payne without a practice. "Congress passed [S]ection 6103 to prevent such damage." *Id.* Since the sum of actual and punitive damages exceeds the minimum statutory damages of $1,000.00 per disclosure, Payne is entitled to the greater amount of the sum of actual and punitive damages. See 26 U.S.C.§ 7431(c). The Court **ORDERS**

the United States to pay Payne the total amount of $1,537,680.00.

22. "[I]n the absence of constitutional requirements[,] the federal courts cannot award interest upon a claim or judgment against the United States unless there has been an express waiver of sovereign immunity." *Holly v. Chasen*, 639 F.2d 795 (D.C. Cir. 1981); *Jackson v. Widnall*, 99 F.3d 710, 716 (5th Cir. 1996). Sections 7430, which details the items that may be awarded against the United States, does not expressly provide for an award of interest to the prevailing party. 26 U.S.C. §§ 7430; *Wilkerson*, 67 F.3d at 120 n.15 ("Nothing in . . . [Section] 7430 indicates that Congress intended to waive its immunity from interest awards."). Thus, "[in] the absence of a clear and unequivocal waiver of immunity from interest awards," Payne is not entitled to prejudgment or postjudgment interest on his damage award against the United States. *Wilkerson*, 67 F. 3d at 120 n.5 (noting that an award of interest against the United States under Section 7430 is improper); see *Miller v. Alamo*, 992 F.2d 766, 767 (8th Cir. 1993) (holding that Congress has not waived the United States's immunity

from interest awards under Section 7430).

23. Section § 7430(a) does, however, authorize "awards of reasonable litigation costs to taxpayers who substantially prevailed in civil tax litigation in which the government's position was unreasonable." *United States v. McPherson*, 840 F.2d 244, 245 (4th Cir. 1988); *McCormack v. United States*, 891 F.2d 24, 25 n.1 (1st Cir. 1989) (quoting 26 U.S.C. § 7430). Section 7430 states that:

> [i]n any administrative or court proceeding which is brought . . . against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty under this title, the prevailing party may be awarded a judgment or settlement for . . . reasonable litigation costs incurred in connection with such court proceeding.

26 U.S.C. § 7430(a). The term "prevailing party" means any party who has substantially prevailed with respect to the amount in controversy or with respect to the most significant issue or set of issues presented. *Id.* at § 7430(c)(4). With respect to the United States's

position, "the inquiry focuses on the reasonableness of the government's position prior to the onset of litigation." *Wilkerson v. United States*, 67 F. 3d 112, 119 (5th Cir. 1995). "Reasonable litigation costs" include reasonable court costs, reasonable expenses of expert witnesses, reasonable cost of any study or analysis, and reasonable fees paid or incurred for the services of attorneys in connection with the court proceeding. *Id.* at § 7430(c)(1). The attorneys' fees,however, "shall not be in excess of $125 per hour unless the court determines that a special factor, such as the limited availability of qualified attorneys for such proceeding, the difficulty of the issues presented in the case, or the local availability of tax expertise, justifies a higher rate." *Id.* at § 7430(c)(1)(B)(ill). Furthermore, Section 7430 limits an award of attorneys' fees to the amount owed to the prevailing party under any contingency fee agreement. *Marre*, 38 F.3d at 829.

24. "[A]n attorney who represents himself in civil tax litigation does 'not pay any fees for legal services nor incur any debts' for the same." *McCormack,* 891 F.2d at 25 (quoting *McPherson*, 840 F.2d at 245).

Consequently, an attorney who represents himself in a proceeding under Section 7431 is not entitled to a counsel fee award for those particular services. *See Id.*

25. In this case, Batista admitted that, on at least one occasion, he violated Sections 6103 and 7431 and the IRS manual and regulations by making third-party contacts before he had given Payne an opportunity to provide the needed records and documents. Despite this admission, the United States still argued that Batista had not disclosed Payne's confidential tax return information and that all of Batista's third-party communications were authorized by statute and regulations. The United States's position was clearly unreasonable, especially given that no determination was made by Batista as to whether the desired documents were otherwise reasonably unavailable.

With the exception of work papers for Payne's 1987 and 1988 tax returns, Batista never asked Payne for any personal tax records and never told Payne the scope of his investigation or the documents that Batista needed. In addition, the United States's even maintained that Batista's questions about Payne's involvement in the use or selling of drugs was

authorized. Batista, not surprisingly, was unable to recall who initially suggested that Payne was involved in drugs. Given the evidence presented at trial, the Court finds that the United States's position was unreasonable and that Payne substantially prevailed in this action on the issue of whether Batista' s third-party contacts were unauthorized disclosures of Payne's confidential tax return information. Payne is, therefore, entitled to reasonable litigation costs incurred in connection with this action.

Although Payne is unable to obtain a fee award for those legal services that he performed himself, Payne may receive an award of reasonable fees paid or incurred for the services of the other attorneys in this case. The Court **ORDERS** that Payne shall file a motion for attorneys' fees and produce clear, complete and verified documentation of all attorney time, hourly fees and litigation expenses, if any, including all expert witness fees incurred in the representation of Payne within ten days (10) days of the date of this Order. Furthermore, counsel shall complete a table indicating the attorney or paralegal by name, hourly rate, total hours and total fees in a form substantially like the one referenced below. Counsel shall separately set forth the amount of costs and expenses incurred.

Timekeeper	Hours	Rate	Total
Expenses			
TOTAL			

The Court further **ORDERS** that the United States's shall have five (5) days after such documentation is produced to file any objections to Payne's attorneys' fees costs and expenses

The Clerk shall enter this Order and provide a copy to all parties.

SIGNED this 19th day of March, 1999

/s/ _____

VANESSA D. GILMORE

UNITED STATES DISTRICT JUDGE

APPENDIX F

REVISED - December 18, 2000

UNITED STATES COURT OF APPEALS
For the Fifth Circuit

No. 99-40205

DENNIS C. GANDY,
Plaintiff-Appellant,

VERSUS

UNITED STATES OF AMERICA,
Defendant-Appellee.

Appeal from the United States District Court
For the Eastern District of Texas

December 11, 2000

Before DAVIS and EMILIO M. GARZA, Circuit Judges,

and POGUE[1], District Judge.

W. EUGENE DAVIS, Circuit Judge:

In this action by Dennis Gandy, a taxpayer, against the United States to recover damages under 26 U.S.C. §7431(a)(1) for wrongful oral and written disclosures of his "tax return information," the district court dismissed the suit and Gandy appeals. The issues on appeal are: 1) whether the district court clearly erred by finding that the statute of limitations began to run on the written disclosures in 1990, and 2) whether the district court erred by holding that the IRS agents made the oral disclosures in good faith. For the reasons that follow, we affirm.

I.

In 1989, IRS Special Agent Ronnie McPherson ("McPherson") was assigned to conduct a criminal investigation of Dennis Gandy ("Gandy") for the years 1985, 1986, and 1987. Special Agent Laura Sanders

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[1] Judge, U.S. Court of International Trade, sitting by designation.

("Sanders") was later assigned to assist with the investigation. On September 19, 1990, McPherson sent a form letter soliciting financial information from 269 customers of the Dennis Gandy Nursery ("Nursery"), which was owned and operated by Gandy. A sentence in the body of the "circular" letter to Gandy's customers stated that Gandy was under investigation by the Criminal Investigation Division of the IRS.

The district court dismissed as time barred both counts of Gandy's complaint seeking recovery for the written disclosures in the circular letter. The court found that Gandy learned in 1990 of the wrongful disclosures the agent made in this letter and that the two year statute of limitations therefore began to run in 1990. Because Gandy filed his complaint in 1996, the court held that the two counts of his complaint concerning the written disclosures made in the letter were time barred.

In addition to Gandy's claim based on the written disclosures, Gandy also sought damages based on oral disclosures. The oral disclosures at issue were made by McPherson and Sanders when they told

potential witnesses and other third parties that they were conducting a criminal investigation of Gandy.

Following a full bench trial, the district court held that McPherson and Sanders believed in good faith, although erroneously, that they were authorized by 26 U.S.C. § 6103 to tell third parties that Gandy was under criminal investigation. The district court dismissed Gandy's suit and this appeal followed.

II.

Gandy argues first that the district court erred in dismissing as time barred his claim for wrongful written disclosure of tax return information. 26 U.S.C. § 7431 acts as a waiver of sovereign immunity for suits seeking damages for wrongful disclosure of tax return information. 26 U.S.C. § 7431(d) provides that a claim for wrongful disclosure of tax return information must be brought "within two years after the date of discovery by the plaintiff of the unauthorized disclosure." If a waiver of sovereign immunity contains a limitations period, a plaintiff's failure to timely file suit deprives the court of jurisdiction. United States v. Dalm, 494 U.S. 596, 608, 110 S.Ct. 1361, 1368 (1990); Dunn-

McCampbell Royalty Interest, Inc. v. National Park Serv., 112 F.3d 1283, 1287 (5th Cir. 1997)(". . . failure to sue the United States within the limitations period is not merely a waivable defense. It operates to deprive federal courts of jurisdiction.").

The district court's finding that Gandy knew of the contents of the written disclosures in the circular letter more than two years before filing the complaint is a factual finding reviewed for clear error. Emmons v. Southern Pacific Transp. Co., 701 F.2d 1112, 1124 (5th Cir. 1983). The court based its finding on the testimony of Patricia Davidson ("Davidson") and Bob Cartwright ("Cartwright").

Davidson, who worked as a receptionist at the Nursery, testified that shortly after the letters were mailed, she answered phone calls from approximately 100 customers who wanted to speak to Gandy about the IRS letter. Davidson testified that she overheard Gandy reassuring these customers that the IRS would clear him of any wrongdoing. Cartwright, one of Gandy's customers, testified that after receiving the letter, he called Gandy and told him he had received a

letter from a criminal investigator.

Gandy testified that he did not have actual knowledge of the contents of the letters. But credibility calls are for the district court and it committed no error in choosing to believe Davidson and Cartwright, rather than Gandy. Thus, the district court's finding that the statute of limitations began to run on the written disclosures in 1990 was not clearly erroneous. Therefore, the district court correctly concluded that the two counts of Gandy's complaint relating to written disclosures were time barred. The district court had no jurisdiction over this claim because the United States has not waived sovereign immunity for untimely suits.

III.

Gandy next argues that McPherson and Sanders made unnecessary disclosures of tax return information when they orally disclosed to potential witnesses that they were conducting a criminal tax investigation of Gandy. The district court held that the United States was not liable for McPherson and Sanders's oral disclosures of Gandy's tax return information because the IRS agents acted under a good

faith, although erroneous, interpretation of 26 U.S.C. § 6103. We review the district court's conclusion that agents McPherson and Sanders acted in good faith as a mixed question of fact and law. We review the court's subsidiary fact findings for clear error and its legal conclusions and application of law to fact de novo. Robicheaux v. Radcliff Material, Inc., 697 F.2d 662, 666 (5th Cir. 1983). The subsidiary facts are undisputed. Therefore, the legal question is whether McPherson and Sanders, as reasonable agents, acted in good faith when they orally disclosed that Gandy was under criminal investigation. We begin our analysis with a consideration of the relevant statutes and the IRS's interpretation of these statutes as reflected in its regulations and manuals.

26 U.S.C. § 6103(a)(1) states that "no officer or employee of the United States . . . shall disclose any return or return information obtained by him in any manner . . . ." The government stipulates that the agents' oral statements that they were conducting a criminal investigation constitute disclosure of return information. However, 26 U.S.C. § 6103(k)(6), which

includes an exception to 26 U.S.C. § 6103(a)(1), provides, in pertinent part:

> An internal revenue officer or employee may, in connection with his official duties relating to any . . . criminal tax investigation . . ., disclose return information to the extent that such disclosure is necessary in obtaining information, which is not otherwise reasonably available, with respect to the . . . liability for tax . . . . Such disclosures shall be made only in such situations and under such conditions as the Secretary may prescribe by regulation.

Id. (emphasis added).

The relevant provisions in the IRS's regulations and manuals are Treasury Regulation § 301.6103(k)(6)-1 and §§ 348.3 and 347.2 of the Handbook. Treasury Regulation § 301.6103(k)(6)-1 states that:

[A]n officer or employee of the Internal Revenue

> Service . . . is authorized to disclose taxpayer identity information (as defined in section 6103(b)(2)), the fact that the inquiry pertains to the performance of official duties, and the nature of the official duties in order to obtain necessary information relating to the performance of such official duties . . . .

Id. (emphasis added). Section 348.3 of the Handbook, entitled Disclosures for Investigative Purposes, provides that:

> Special agents are specifically authorized by I.R.C. § 6103(k)(6) to disclose return information to the extent necessary to gather data which may be relevant to a tax investigation. Situations in which special agents may have to make such disclosures in order to perform their duties arise on a daily basis. For example, this occurs whenever they contact third parties believed to have information pertinent to a tax investigation.

Section 347.2 of the Handbook deals specifically with

circular letters sent out by IRS agents.[2] At the time the agents made the oral disclosures at issue - before it was changed in 1992[3] - § 347.2 of the Handbook provided that:

> Caution must be exercised not to damage the reputation of the taxpayer by making the letter either offensive or suggestive of any wrongdoing by the taxpayer. It must not be disclosed in the body of the letter that the taxpayer is under investigation by the Criminal Investigation Division. Appropriate wording could be "The Internal Revenue Service is conducting an investigation of . . .". [sic] Any reference to the Criminal Investigation Division must be restricted to the signature blocks or ancillary headings. . . . The title "Special Agent" and

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[2]Circular letters are form letters sent out in mass mailings to gather information about a taxpayer under investigation.

[3]We look to the provisions in the regulations and manuals as they existed at the time of the oral disclosures, regardless of any subsequent changes. All statements regarding these provisions refer to the provisions as they existed at the time.

Criminal Investigation Division will be included in the signature block."

The district court held that the oral disclosures at issue were not necessary. However, we need not decide the difficult legal question of whether agents McPherson and Sanders's oral disclosures that Gandy was under criminal investigation were necessary if we agree with the district court that agents McPherson and Sanders, as reasonable agents, were in good faith in believing that the disclosures were authorized and therefore necessary. We therefore turn to the United States' good faith defense.

26 U.S.C. § 7431 supplies a civil remedy for violations of 26 U.S.C. § 6103. However, § 7431(b) provides that "[n]o liability shall arise under this section with respect to any inspection or disclosure--(1) which results from a good faith, but erroneous, interpretation of section 6103 . . . ." Id. (emphasis added). This court defined the test for good faith under 26 U.S.C. § 7431(b) in Huckaby v. United States, 794 F.2d 1041 (5th Cir. 1986). We stated that "the good-

faith defense in section 7431(b) should be judged by an objective standard analogous to that employed in Harlow. . . . Harlow would find officials acting in good faith when 'their conduct does not violate clearly established statutory or constitutional rights of which a reasonable person would have known.'" Id. at 1048 (quoting Harlow v. Fitzgerald, 457 U.S. 800, 818, 102 S.Ct. 2727, 2738 (1982)).

We later stated in Huckaby that:

> The question then, as we have noted, is whether a reasonable IRS agent would be acquainted with the statute, and his own agency's interpretation of the statute as reflected in its regulations and manuals. The answer is self-evident. A reasonable IRS agent can be expected to know the provisions of sections 6103 and 7431, as they may be further clarified by IRS regulations and other IRS interpretations.

Id. at 1048-49 (footnote omitted).[4]

This Court interpreted the good faith provision of 26 U.S.C. § 7431(b) once again in Barrett v. United States, 51 F.3d 475 (5th Cir. 1995). We stated that "[a] reasonable IRS agent can be expected to know statutory provisions governing disclosure, as interpreted and reflected in IRS regulations and manuals." Id. at 479 (citing Huckaby, 794 F.2d at

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[4]Gandy also argues that in addition to the factors listed by this Court to determine whether an agent has acted in good faith, another factor is federal court decisions. Gandy cites three cases from other circuits: Heller v. Plave, 657 F.Supp 95 (S.D. Fla. 1987), Rodgers v. Hyatt, 697 F.2d 899 (10th Cir. 1983), and May v. United States, 141 F.3d 1169 (8th Cir. 1998)(unpublished opinion), as well as Johnson v. Sawyer, 640 F.Supp. 1126 (S.D. Tex. 1986) and Huckaby v. United States, 794 F.2d 1041 (5th Cir. 1986). He argues that these cases prohibit the oral disclosures at issue in this case. However, the only case Gandy relies on that involves an agent's oral disclosure to a potential witness that the taxpayer is under criminal investigation is a case from the Southern District of Florida - Heller. We decline to impose a burden on agents to follow a single district court opinion, particularly from a jurisdiction outside the territory in which they work.

1048). We stressed the importance of the agent following the procedures and rules that are found in the Handbook. We concluded that the disclosure in Barrett was not in good faith because "the Chief of the Criminal Investigation Division had not approved the content of the circular letters as required by Chapter 347.2 of the IRS 'Handbook for Special Agents.'" Id. at 479.

With this background, we now consider the arguments of the parties.

IV.

Gandy argues that a reasonable IRS agent could not have acted in good faith in orally disclosing that Gandy was under criminal investigation when § 347.2 of the Handbook prohibits such a disclosure in circular letters - a form of written disclosure. Gandy argues that no reasonable agent could interpret the IRS regulations and manuals to authorize a statement if it is made orally, while forbidding it in a written disclosure.[5]

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[5]Gandy also argues that McPherson and Sanders should have been aware of instructions of IRS supervisors within their district prohibiting an agent from saying that a taxpayer is under

We agree with the United States that § 347.2 of the Handbook does not control the question of whether the agents acted in good faith by orally disclosing that Gandy was under criminal investigation. Section 347.2 does not purport to have general application to all disclosures; it is expressly limited to circular letters, which are by definition mailed to large numbers - sometimes hundreds - of potential witnesses.

In contrast to circular form letters mailed to hundreds of business contacts, oral disclosures are typically made during one-on-one contacts with potential witnesses. These contacts are much more focused than a mass mailing. Also, agents are obviously more selective in choosing these witnesses with whom they will personally meet. Because of the differences in the nature of the circular letter or mass mailing and the personal contact where oral

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criminal investigation. These alleged instructions were described at trial by a former IRS Criminal Investigation Division supervisor, Vernon Hampton. However, the district court was not compelled to credit Hampton's testimony, or to find that a reasonable agent should have been aware of these comments.

disclosures are typically made, we are persuaded that a reasonable agent would conclude that the specific rules governing written disclosures in circular letters would not apply across the board to all disclosures, including oral disclosures.

Treasury Regulation § 301.6103(k)(6)-1 and § 348.3 of the Handbook buttress this conclusion and tend to support an agent's conclusion that he can orally inform a potential witness that he is conducting a criminal investigation. Treasury Regulation § 301.6103(k)(6)-1 provides that an IRS agent may disclose the "nature of the [his] official duties . . ." when conducting an investigation of a taxpayer. This would lead agents McPherson and Sanders, as reasonable agents, to conclude that they were authorized to disclose the nature of their official duties as a criminal tax investigation.

Section 348.3 of the Handbook provides further support for this conclusion. This section provides that "[s]ituations in which special agents may have to make such disclosures [of return information] in order to perform their duties arise on a daily basis. For

example, this occurs whenever they contact third parties believed to have information pertinent to a tax investigation."

Also, it is clear to us that agents are authorized to display their credentials and badges identifying them as Criminal Investigation Division agents when interviewing a third party.[6] Knowledgeable persons know that agents in the criminal division conduct only criminal investigations. An agent's knowledge that his badge identifies his area of investigation further supports a reasonable agent's conclusion that he is authorized to orally disclose - what the third party probably already knows - that the agent is conducting a criminal investigation.

For all the reasons stated above, we agree with the district court that agents McPherson and Sanders, as reasonable agents, had a good faith belief that they

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[6]Section 977(11).1(4) of the Internal Revenue Manual currently states - as it did at the time of McPherson and Sanders's oral disclosures - that "a special agent will properly identify himself/herself by producing his/her pocket commission at the time of the interview."

could disclose the criminal nature of the investigation.

AFFIRMED.

APPENDIX G

Revised August 22, 2000

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 99-60074

JERRY S. PAYNE,

Petitioner-Appellant,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the Decision of the
United States Tax Court

August 17, 2000

Before JONES, DUHÉ, and WIENER, Circuit Judges.

WIENER, Circuit Judge:

Petitioner-Appellant Jerry S. Payne appeals an adverse decision of the Tax Court, which awarded

Respondent-Appellee Commissioner of Internal Revenue ("the government" or "the IRS") $438,722 in delinquent income taxes and penalties for tax years 1987 and 1988, plus interest. As a general rule, the IRS must assess taxes within three years following the date that the return is filed. Here, the IRS did not send Payne a notice of deficiency (an event that tolls the statute of limitations pending assessment) until more than three years after he had filed his return for each of those years. The Tax Court found, nevertheless, that the IRS's collection action was timely under the statutory fraud exception to the three-year statute of limitations.[1] As it had to if it were to determine taxpayer fraud, the Tax Court found the government's evidence of fraud to be clear and convincing. But in our clear error review, we see that evidence as weak and equivocal, so that disregarding the statute of limitations cannot be justified on grounds of tax fraud. The judgment of the Tax Court is therefore reversed and judgment rendered in favor of Payne, granting his petition for redetermination of income taxes, penalties,

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[1] 26 U.S.C. § 6501(c). Unless otherwise noted, all statutory citations under Title 26, United States Code, are to the Internal Revenue Code of 1986, as amended.

and interest for 1987 and 1988 and holding that the government is barred by the statute of limitations from collecting anything from Payne for those tax years.

I.
FACTS AND PROCEEDINGS

Payne is a lawyer. During the years at issue he practiced law, concentrating in litigation. Payne provided extensive legal representation to, and eventually came to own, a corporation called 2618, Inc. ("2618") which, as sole proprietor, operated Caligula XXI, a topless dance club (the "club") in Houston, Texas. Payne also represented Gerard Helmle, one of 2618's two equal shareholders and the club's manager. Among other things, Payne defended Helmle against a criminal charge for possession of illegal drugs. Most of the operable facts of this case arise out of these professional representations.

At the beginning of 1987, Helmle and Leo Kalantzakis each owned one-half of the stock of 2618. As prerequisites to operating a topless dance club in Houston, 2618 needed both (1) a liquor license, technically a Mixed Beverage Permit, from the Texas Alcoholic Beverage Commission (the "TABC"), and (2)

a Sexually Oriented Business Permit ("SOB permit") from the City of Houston ("the City"). The SOB permit was required by a Houston ordinance passed in 1986 which provides, inter alia, that one topless dance club cannot operate within 1,000 feet of another. The ordinance also specifies that if two such dance clubs seeking SOB permits are located within 1000 feet of each other, a permit can be issued only to the club that has been in operation longer. As part of his representation of 2618, Payne helped it apply for an SOB permit. The club was located within 1000 feet of a competing topless dance establishment, however, so 2618's application for an SOB permit was denied. The Tax Court recognized that without an SOB permit the club's viability was in serious doubt.

Payne filed suit against the City to force issuance of an SOB permit to 2618. The primary issue in the suit was which club had been in operation longer.

While that suit was proceeding in state district court, Helmle and Kalantzakis, had a falling out. Their dispute resulted in litigation between 2618 and Kalantzakis, in which Payne represented the corporation. Ultimately this matter was settled by

Helmle's agreeing to purchase Kalantzakis's stock in 2618, which would leave Helmle as the corporation's sole stockholder.

By this time, Payne had amassed substantial unpaid accounts receivable resulting from his criminal defense of Helmle and his representation of 2618 in several matters. Helmle did not have the financial wherewithal either to fund his purchase of Kalantzakis's stock or to pay Payne's account. The club was Helmle's sole source of income, and his dispute and eventual settlement with Kalantzakis threatened the continued existence of the club. Payne was aware that the club's survival represented his only realistic possibility of ever recovering his fees for legal services rendered to Helmle and to 2618. As neither Helmle nor 2618 was creditworthy, Payne borrowed $275,000 from Texas Guaranty National Bank then lent that same sum to Helmle, who used these funds to purchase Kalantzakis's stock in 2618.

Payne and Helmle agreed that Helmle would cause 2618 to make monthly payments to Payne so that he, in turn, could make periodic payments of principal and interest on the bank loan. In essence, Payne acted as an intermediary, first in borrowing

from the bank and passing the loan proceeds through to his client, and then in receiving funds from his client and immediately disbursing those funds to the bank that had made the loan.

Helmle also agreed to compensate Payne for his increased involvement in the club's operations during this period by paying him a management fee. Payne reported the management fee on his income tax returns for the years in question. He did not, however, report the sums that he received from his clients and then immediately remitted to the lender bank. As to these he took the position that he was a mere accommodation borrower and conduit through which the loan proceeds and repayments passed, not a party in interest to an income-producing transaction.

During the time that Kalantzakis owned one-half of the stock of 2618, he had handled the renewals of the corporation's mixed-beverage permit from the TABC. Kalantzakis had apparently developed relationships with high-level personnel at the TABC, which helped expedite the permit renewal process. After Kalantzakis's split with Helmle and Helmle's subsequent purchase of Kalantzakis's stock, however, Kalantzakis was no longer willing to use his

relationship with TABC officials for the corporation's benefit. In fact, there are allegations that Kalantzakis lobbied his contacts at the TABC to deny renewal of 2618's mixed-beverage permit. Payne contends that ultimately, through its relationship with Kalantzakis, the TABC learned that criminal drug charges were pending against Helmle. This prompted the head of enforcement for the TABC to determine that, because Helmle was the sole owner of 2618, its mixed-beverage permit should not be renewed.

Payne counseled Helmle that his best solution was to sell the club. Helmle agreed and authorized Payne to find a buyer. Unfortunately for Helmle, though, all potential buyers that Payne contacted lost interest when they discovered that the City had denied the club's application for an SOB license and that the TABC was refusing to renew the club's mixed-beverage permit.

After trying unsuccessfully to preserve any going-concern value that the club might have (apparently at this point, there was little or none), Payne foreclosed on encumbrances of 2618's assets that he held as security for unpaid legal fees. Specifically, Payne foreclosed on the corporation's (1) leasehold

interest in the building in which the club operated, (2) furniture, furnishings, fixtures, and leasehold improvements in the building, and (3) right to use the name Caligula XXI. Payne concluded that the assets he foreclosed on had a fair market value of $35,000 and reported this amount as income on his federal income tax return. Payne leased the assets back to 2618 in the hope that the liquor license and SOB permit would be issued, which should make it possible for Helmle or 2618 to pay the remaining legal fees owed to Payne.

After they failed to find a buyer for the club and determined that the reason the TABC would not issue a mixed-beverage permit to 2618 was the criminal charges pending against Helmle, Payne and Helmle embarked on a new strategy to secure a mixed-beverage permit: They entered into a conditional stock-purchase agreement under which Payne agreed to buy all issued and outstanding 2618 stock from Helmle in consideration of Payne's $500,000 note, when and if 2618 secured a mixed-beverage permit. Payne reasoned that when the TABC realized that its issuance of a permit to the club would terminate Helmle's ownership, the TABC would grant the mixed-beverage permit. Payne negotiated with the TABC for

the renewal of the club's permit, but when these negotiations broke down he filed suit against the TABC. The lawsuit was ultimately settled when the TABC agreed to issue the club a mixed-beverage permit. This satisfied the condition precedent in the stock purchase agreement between Helmle and Payne, causing the stock to be transferred to Payne in exchange for his note and making him the sole shareholder of 2618.

Shortly after the stock was transferred to Payne, Helmle agreed to reduce the sum due on Payne's note from $500,000 to $300,000. Even so, Payne never made any payments on the note.

The Tax Court found the credit sale of the stock from Helmle to Payne to be a sham transaction, and reclassified the transfer of the stock from Helmle to Payne as an in-kind payment for past legal services. On appeal, Payne does not contest the Tax Court's characterization of the transaction as a payment in-kind for legal fees. Rather, he contends that the 2618 stock was worthless at the time he received it from Helmle. As such, urges Payne, he was correct in concluding that he need not report receipt of the valueless stock as income from his law practice.

Payne based his conclusion of worthlessness on

the specter of the litigation that was then pending between 2618 and the City concerning the denial of the club's SOB permit. Without an SOB permit the club could not operate; and, in Payne's considered professional opinion, 2618's odds of success in that suit were abysmal. Furthermore, the liquor license was the corporation's only significant asset; it had no SOB permit and no longer owned (1) its leasehold interest in the only location where it was licensed to sell liquor, (2) the leasehold improvements needed to conduct the dance club operations, or (3) the trade name under which the club operated. Those assets had long since been lost to Payne through foreclosure, a transaction on which Payne had reported income. In Payne's estimation, these factors combined to render the stock worthless on the date he acquired it.

The IRS prosecuted Payne for criminal tax fraud on facts arising from essentially the same transactions that are at issue in this case — and Payne was acquitted. During the pendency of the criminal tax prosecution, Payne filed a civil suit against the IRS for divulging confidential tax information during its criminal investigation. Payne's civil suit against the IRS resulted in a $1.7 million judgment for Payne. The government's appeal of that decision is currently pending before this court.

II.
ANALYSIS

A. Jurisdiction and Standard of Review

We have jurisdiction to review decisions of the Tax Court pursuant to I.R.C. § 7482. We review such decisions "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury."[2] Accordingly, findings of fact are reviewed for clear error and conclusions of law are reviewed de novo.[3]

B. Statute of Limitations

This appeal is governed by § 6501 of the Internal Revenue Code. Subsection (a) of § 6501 proclaims the general rule that "the amount of any tax imposed by this title [Title 26, U.S.C.] shall be assessed within 3 years after the return was filed," otherwise any collection effort by the government shall be time

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[2] 2I.R.C. § 7482(a). See also Commissioner v. McCoy, 484 U.S. 3, 6 (1987).

[3] Fed. R. Civ. P. 52(a); Sealy Power Ltd. v. Commissioner, 46 F.3d 382, 385 (5th Cir. 1995).

barred. As the three-year period set forth in § 6501(a) is tolled by the issuance of a statutory notice of deficiency,[4] that general rule of limitation can be rephrased to read: Unless a statutory notice of deficiency is sent to the taxpayer within 3 years after the return was filed, the government's collection effort shall be time barred.

In this case, the government sent the statutory notices of deficiency for both 1987 and 1988 more than three years after Payne had filed his returns for those years. Thus, unless an exception to the three-year limitations period is applicable, notices of deficiency were issued too late, and the government is barred from collecting the tax deficiencies, penalties, and interest it now asserts.

The only exception to the general three-year limitations rule of § 6501(a) that is implicated in this appeal is § 6501(c)'s statutory tax fraud exception, which provides: "In the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time."

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[4] § 6503(a).

The burden of proving fraud is on the government.[5] To satisfy its burden, the government must prove, by clear and convincing evidence, that at least some portion of the asserted underpayment of tax is the result of fraud.[6] If the government carries this high burden with respect to any part of the underpayment, "the entire underpayment shall be treated as attributable to fraud, except with respect to any portion that the taxpayer establishes (by a preponderance of the evidence) is not attributable to fraud."[7] We have defined fraud in the following terms: "Fraud implies bad faith, intentional wrongdoing and a sinister motive. It is never imputed or presumed and the court should not sustain findings of fraud upon circumstances which at most create only

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[5] § 7453(a) ("In any proceeding involving the issue whether the petitioner has been guilty of fraud with the intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary").

[6] See, e.g., Webb v. Commissioner, 394 F.2d 366, 377 (5th Cir. 1968).

[7] § 6653(b)(2) (1988). In 1989, this provision was recodified as § 6663(b).

suspicion."[8] Fraud is usually inferred from "conduct, the likely effect of which would be to mislead or conceal."[9]

As a general rule, the government's determination of a tax deficiency is presumptively correct. A consequence of this presumption is that the taxpayer bears the burden of proving that the government's determination is incorrect or arbitrary.[10] We and other courts have held, however, that when the government relies on an exception to the three-year statute of limitations, it bears the burden of proving its entitlement to rely on that exception.[11] This means that alone the general presumption of the correctness of the

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[8] Webb, 394 F.2d at 377.

[9] Spies v. United States, 317 U.S. 492, 499 (1943).

[10] United States v. Janis, 428 U.S. 433, 440-41 (1976); Tax Ct. R. 142(a); 14 Mertens, Law of Federal Income Taxation § 50:437, p.50-399 (April 2000 rev. ed.).

[11] Armes, 448 F.2d at 974 (government must prove substantial omission from gross income by a preponderance of the evidence); Drieborg v. Commissioner, 225 F.2d 216, 218 (6th Cir. 1955) (government must prove fraud by clear and convincing evidence).

government's deficiency determination cannot serve to establish fraud on the part of the taxpayer; proof of fraud remains the burden of the government. Indeed, to hold otherwise would be to ignore the statute and the related case law that impose on the government the burden of proving fraud by clear and convincing evidence.[12] There must be additional evidence, independent of the general presumption of correctness, from which fraudulent intent on the part of the taxpayer can be properly inferred.[13]

The government asserts that its most compelling evidence of fraud — and therefore the evidence most likely to surmount the clear and convincing evidence threshold — lies in the 2618 stock transfer from Helmle to Payne. Before the Tax Court, the government introduced an expert report that appraised the stock at $1.14 million as of the date of the transaction. This conclusion was expressly predicated on the expert's assumption that 2618 would continue to operate a topless club "indefinitely." That

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[12] § 7454; Goldberg v. Commissioner, 239 F.2d 316, 320 (5th Cir. 1956).

[13] Drieborg, 225 F.2d at 218.

assumption, however, was directly contrary to the facts as they existed on the date Payne acquired the stock, the only date relevant to the appraisal. At that time, the City was steadfastly refusing to grant 2618 an SOB permit, which all concede was an absolute necessity if the club was to continue operating.

Aware of this flaw in the expert's analysis, the Tax Court "conclude[d] that [the government's] expert's [$1.14 million] valuation for the stock of [2618] should be reduced by a discount of 50 percent to reflect the risks associated with the litigation over the [SOB license]." In essence, the court began by agreeing with the government expert that, with the SOB license, the stock was worth $1.14 million and concluding that, without that license, the stock was worthless. Then simplistically — without any analysis or expert evidence of the odds of success in the license litigation — the Court arbitrarily split the difference. Consequently, the Tax Court found the stock's value, at the time Payne received it, to be $570,000, exactly half-way between zero and $1.14 million. The Tax Court then jumped directly to its ultimate conclusion that Payne's "failure to report any amount as income in

connection with his receipt of the stock was part of [his] fraudulent conduct."

For the following reasons we find clearly erroneous the Tax Court's conclusion that Payne's failure to report the stock transfer from Helmle is clear and convincing proof of fraudulent intent. First, we are skeptical of the Tax Court's conclusional finding that, at the time the stock was transferred to Payne, there was a 50 percent chance that 2618 would win the litigation and get the SOB permit. Payne assigned a far smaller chance that this would be the outcome of the suit; and it seems to us that, as the attorney representing 2618 in that ongoing litigation, Payne was in the best position to assess 2618's chances. But even if we were to disregard Payne's opinion as incredible, we cannot disregard the government's failure to adduce evidence, expert or otherwise, on this question. Our review of the record reveals no evidence that we see as probative on this point.

Second, the Tax Court's analysis is predicated on the conclusions of the government's expert as announced in his report. We have examined this report and find that it contains internal flaws not discussed

by the Tax Court. For example, the report included the following qualification: "The subject assets, properties or business interests are appraised free and clear of any or all liens or encumbrances . . . ." Based in part on this statement and in part on other indicia in the report, we are convinced that the expert was appraising not only the going concern value of 2618's business with licenses in place, but was also assigning value to the corporation with its lease, leasehold improvements, and trade name in place, specifically, the leasehold interest in the building where the club operated, the furniture, fixtures, equipment, and the leasehold improvements used in nightly operations, and the Caligula XXI name. As we previously noted, though, Payne had already foreclosed on those assets in a separate transaction months earlier, one on which he reported income and to which neither the Tax Court nor the government has ascribed fraudulent intent. It is fallacious, therefore, to treat the assets lost by 2618 through foreclosure as contributing to the value of the stock on the date, months later, that it was acquired by Payne in an entirely separate transaction. Even with an SOB permit, how could 2618 operate the club

without its trade name, the only location from which it was authorized to conduct its dance and liquor business, and its furniture, fixtures and leasehold improvements?[14]

Third, the Tax Court's analysis fails to take into account the delay and expense associated with litigating the licensure issue with the City. The government's expert's report qualified its conclusion that if the club were to operate indefinitely its value was $1.14 million; the expert opined that the club's value was $1.14 million "net of any costs associated with removing any impediments preventing operation as a topless club. Such costs would be expected to include legal fees and associated costs." The report went on to explain that two "key parameters need to be assessed with respect" to its projection of value:

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[14] The government urged both before the Tax Court and on appeal that Payne's representations to third parties that the club had a value in the millions constituted evidence that he perpetrated tax fraud when he did not report receipt of the stock as income. We note, however, that all of Payne's representations cited by the government were premised on the assumption that the SOB permit would be issued, which had not occurred at the time of the stock transfer, and that these other business assets were still owned by the corporation. These representations do not, therefore, constitute evidence of fraud.

> [1] the legal avenues available to contest closure under the [SOB] ordinance and [2] the cost of pursuing such remedies. At this time, we believe the estimate of these parameters would necessarily have been speculative as of the valuation date. We have not reviewed information or conducted discussions with individuals who could provide reliable analyses of the relevant legal issues and corresponding costs. As a result, we have not drawn a conclusion with respect to these specific circumstances.

Despite this significant and substantial qualification in the expert's report, the government did not offer evidence regarding these "key parameters" and the Tax Court did not reduce the $1.14 million estimate to reflect the negative effect these factors might have on the price a willing buyer would pay for the stock.

Taken together, the foregoing shortcomings in the Tax Court's analysis and the expert report on which it relied compel us to conclude that the Tax Court's finding on valuation is not supported by the record. Essentially, the Tax Court began with a value

that was too high because it ignored the costs of litigating the SOB licensure, and because it included the assets on which Payne had already foreclosed. The court then discounted this inflated figure by 50 percent "to reflect the risks associated with litigation" over the SOB permit. We find no evidence in the record supporting the Tax Court's conclusion that 50 percent was an appropriate discount. The product of the inflated value and the arbitrary — and likely excessive — odds that the Tax Court assigned to a favorable outcome, i.e., to the issuance of an SOB permit, yield a conclusion as to the value of 2618's stock that we find untenable.

The Tax Court noted that its $570,000 valuation conclusion approximated the amount of Payne's outstanding legal bills with 2618 and Helmle at the time of the stock transfer, and suggested that this "further supported or corroborated" the determination that the stock was worth $570,000 when Payne acquired it. The record indicates, however, that Helmle was not creditworthy at the time of the stock transfer, and had proved himself unable to remit payment for legal services to Payne in a timely fashion, if at all. We agree with the Tax Court that if an attorney and his

creditworthy client had arranged an arms-length in-kind payment, the value of the property transferred in payment should approximate the value of the legal services for which payment is being made. But this logic breaks down when, as here, the client is not creditworthy and, indeed, has no other assets: An attorney with a substantial account receivable owed by an insolvent client may well have an account receivable with a value of zero. Any such creditor is likely to accept even valueless assets when essentially "writing off" a receivable from an insolvent debtor. We cannot agree with the Tax Court that the amount Helmle owed Payne supports the court's valuation of the 2618 stock. Perhaps the Tax Court concluded that, because the $500,000 note that Payne gave to Helmle in exchange for the stock was a sham, it constituted evidence of fraudulent intent. And, if the court did so conclude, it may well have been correct. But any fraud associated with that element of the transaction was just as likely if not more likely directed at some other party — e.g., the City or the TABC[15] — as at the IRS.

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[15] There is no dispute that Helmle's ownership of 2618 impeded its ability to secure licenses and permits from these

Consequently, even if we assume arguendo that the sham credit sale might constitute clear and convincing evidence of fraud, it is not clear and convincing evidence of tax fraud.

There is no direct evidence in the record of any deceptive or evasive conduct by Payne. The government argues, nevertheless, that Payne's fraudulent intent could be inferred from his failure to report income stemming from the stock transfer. To infer fraud from this transaction, though, one first has to accept the conclusion that the stock had value when Payne received it, a conclusion about which we are dubious.

Even if we assume for purposes of argument that the Tax Court did not clearly err when it determined that the stock had substantial value at the time Payne received it, we are nevertheless left with the firm conviction that the court clearly erred when it concluded that this transaction and Payne's omission

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agencies; however, it is likely that if Helmle merely transferred nominal title to Payne, his attorney, for no consideration, the transfer would have been viewed as a nullity by these agencies and would not have achieved its stated purpose — facilitating licensure of the club.

of its value from his tax return constitute clear and convincing evidence of fraud. "The fraud meant is actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing."[16] Payne's explanation is that he believed the stock to be worthless, and we find his explanation to be plausible — at least as plausible as the government's competing explanation that (1) the stock had substantial value when Payne received it, and (2) that Payne knew this and thus believed he owed tax but did not report it.

The question before us is whether the Tax Court committed clear error when it found that the government proved the fact of fraud by clear and convincing evidence. "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed."[17] Judged against this standard, we find clearly erroneous the Tax Court's determination that

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[16] Mitchell v. Commissioner, 118 F.2d 308, 310 (5th Cir. 1941).

[17] Commissioner v. Duberstein, 363 U.S. 278, 291 (1960).

the government proved fraud by clear and convincing evidence.

As we observed, the government asserts that Payne's return position on the stock transfer presents its strongest case for tax fraud. Consequently, if the evidence about that transaction fails to surmount the clear and convincing evidentiary hurdle, then a fortiori the evidence about other transactions in which Payne was involved, proffered by the government to support its contention of fraudulent intent, must also fail. As the possibility nevertheless remains that the cumulative effect of all of the government's evidence could constitute clear and convincing evidence of tax fraud, we have closely scrutinized the entire record in search of evidence of fraud that might enhance the evidence that we have discussed. Our review of the record only serves to reinforce our conclusion that the Tax Court clearly erred in finding that the government proved fraud by clear and convincing evidence. Accordingly, we are constrained to reverse the Tax Court's determination that Payne filed his tax returns with fraudulent intent. Consequently, the statutory fraud exception to the three year statute of limitations is not available to the government. As the

government's deficiency notices for 1987 and 1988 were not duly furnished within the applicable three-year period under the statute of limitations provided in § 6501(a), collection of additional taxes, penalties, and interest for those years is time barred. The Tax Court therefore erred reversibly in applying the statutory fraud exception of § 6501(c) and denying Payne's petition for redetermination of taxes, penalties, and interest assessed pursuant to those tardy notices of deficiency.

III.
CONCLUSION

The expansive record in this case certainly demonstrates that Payne has no acumen for keeping orderly records of his financial dealings; and we sympathize with the government and the Tax Court for the difficulty they faced in reconstructing Payne's financial affairs and then attempting to determine their tax consequences. In addition, we are aware that, in some cases, poor record keeping has been deemed indicative of fraud. But, as there is little else in this record to suggest that Payne had direct fraudulent intent,

his deficiency in record keeping is not sufficient to sustain the government's burden of proving fraud to the required degree.

At bottom, the competing contentions of the parties are obvious. Payne insists that, for the years in question, his allowable deductions exceeded his taxable income and, believing that he would not owe any taxes, he paid little attention to the preparation of his returns. In contrast, the government urges that when Payne prepared and filed his returns, he did so with the intention of understating his income tax liability. Despite our painstaking review of the record, we are unable to determine which of these competing positions more closely comports with reality. We are able to determine from our record review, however, that the government has failed to support its version with evidence any more convincing than the evidence that Payne has adduced in support of his version. This evidentiary equipoise results in a draw, leaving us with the firm conviction that the government has failed to carry its burden of proving fraud by the heightened clear and convincing standard. We hold, therefore, that the

Tax Court erred reversibly in allowing the statutory fraud exception to prevail over the three-year statute of limitations.

The judgment of the Tax Court is reversed for the foregoing reasons and judgment rendered in favor of Payne, granting his petition for redetermination and holding that the government is time barred from collecting additional taxes, penalties, and interest from Payne for his tax years of 1987 and 1988.

REVERSED and RENDERED.

APPENDIX H

CONGRESSIONAL PRE-9/11/01 FORMULA TO AVOID UNNECESSARY HARM TO THE TAXPAYER

In 1976, after Congressional hearings demonstrated widespread harm to taxpayers from disclosures to third parties that a taxpayer was under criminal investigation, Congress enacted Section 6103 of the Internal Revenue Code. The central theme of Congress' 1976 formula, as effectuated by Treasury Regulation 301.6103(k)(6)-1, is the creation of conditions precedent to an IRS police officer's grant of authority to disclose the identity of a taxpayer to third parties. The structure of the regulations implementing Congress's formula in Section 6103 requires an IRS police officer to make a threshold evaluation ("Level One") of the need to disclose the identity of the taxpayer to third parties. The structure of the formula is as follows:

INTERNAL REVENUE CODE SECTION 6103

(a). All return information, including the taxpayer's name and that the taxpayer is under criminal investigation, is confidential and may not be disclosed except as provided in Section 6103(k)(6).

Section 6103(k)(6) allows an IRS police officer to disclose return information to the extent that such

disclosure is necessary to obtain information which is not otherwise reasonably available.

The last sentence of Section 6103(k)(6) contains an additional condition precedent to an IRS police officer's authority to disclose return information – "Such disclosures shall be made only in such situations and under such conditions as the Secretary may prescribe by regulations."

TREASURY REGULATION 301.6103(K)(6)-1

Treasury Regulation 301.6103(k)(6)-1 was enacted to effectuate Congress's mandate in IRC, Section 6103 to avoid unnecessary harm to taxpayers from the disclosure that the taxpayer is under criminal investigation. The regulation is structured in a manner that requires two levels of consideration. (The IRS has conceded the existence of a "Level One" condition precedent to an IRS police officer's authority to disclose a taxpayer's identity to third parties. (See page 5 of this document, IRS's opening statement at trial).

(a). Level One – The first level that an IRS police officer must consider and evaluate before disclosing a taxpayer's identity to a third party is set out in Regulation 301.6103(k)(6)-1(a). This first provision of the regulation describes the conditions precedent to an IRS police officer's grant of authority to disclose the name of a taxpayer to a third party. This section of the

regulation grants authority to disclose the identity of the taxpayer to a third party only if the information sought is not otherwise reasonably available without disclosing the name of the taxpayer under investigation.

A level one evaluation and determination is the threshold through which an IRS police officer must pass to have authority to disclose to a third party the identity of the taxpayer under criminal investigation An IRS police officer may not go to "level two" (*i.e.* Section 1(b)) and disclose the taxpayer's name until the officer has made a good faith determination, as required by Section 1(a) of the regulation. (Appendix K is Regulation 301.6103(k)(6)-1)

(b.) Level Two–The second level that an IRS police officer must consider and evaluate is set out in Section 301.6103(k)(6)-1(b). This section of the regulation sets out the conditions precedent to an IRS police officer's authority to disclose return information to a third party, after said police officer has passed through the required evaluation threshold in Section 1(a) and has authority to disclose the taxpayer's name.

c.) The last sentence of Section 6103(k)(6) specifically limits an IRS police officer's authority to disclose "return information" to the "situations and under such conditions as prescribed by the regulations;" therefore, any disclosure of a taxpayer's name by an IRS police officer who did not undertake the threshold evaluation required by Regulation 301.6103(k)(6)-1(a) is unauthorized.

THE IMPORTANCE AND SIGNIFICANCE OF TREASURY REGULATION 301.6103(k)(6)-1(a)

Treasury Regulation 301.6103(k)(6)-1(a) ("Level One") contain the most critical and significant provisions for preventing unnecessary harm to a taxpayer from an IRS police officer's disclosure that the taxpayer is under criminal investigation. A pragmatic analysis of the IRC, treasury regulations, and special agent handbooks, demonstrate the significance and importance of "Level One" in preventing unnecessary disclosures of a criminal investigation by the IRS police.

The court decisions interpreting the statutes, regulations, and handbooks, demonstrate that when an IRS police officer contacts third parties, that it is inevitable that the third party will acquire knowledge that the taxpayer is under a criminal investigation This knowledge is acquired during an in-person interview when the IRS police officer shows his badge, states the nature of his duties, his affiliation with the "Criminal Investigation Division" of the IRS and discloses the taxpayer's name. If the third party contact is made through letters or other written communications, the third party will acquire knowledge that the taxpayer is under criminal investigation from ancillary headings, return receipt documents or other places where the term "Criminal Investigation Division" and/or "Special Agent" is disclosed in the writing.

Treasury Regulation 301.6103(k)(6)-1(a) was promulgated to effectuate Congress's intent with this pragmatic analysis in mind. If the condition precedent in "Level One" is eliminated, Congress's intent to prevent unnecessary disclosure to third parties that the taxpayer is under a criminal investigation is negated.

IRS'S OPENING STATEMENT AT TRIAL

"Your Honor, this case is fundamentally about unauthorized disclosures under Sections 7431 of the IRS Code. That makes a direct reference to Section 6103.

"It is our contention, your Honor, in this particular case to show you that there are essentially two or three levels that we need to consider. The first level is whether or not Mr. Payne was cooperating and whether or not the IRS agents needed to gather evidence from the sources that they contacted."

* * *

"The agents were more than justified in concluding that Mr. Payne was not cooperating when they went out and began to summon banks for records and when they went and began to contact his clients.

"If we reach that conclusion, your Honor, then this case becomes very simple. The issue then becomes once they contacted those other

banks or clients, did they say something or write something which was, in fact, a disclosure. And, if so, was it authorized as an investigative disclosure because they needed to disclose that in order to get the witness to cooperate and give them information." (TR, Vol. I, 19 – 23)"

Appendix I

Examples Provisions Of Amended Regulations That Demonstrate "Significant Regulatory Action."

(a.) The temporary regulations amend the existing regulations to clarify and elaborate on the facts and circumstances in which disclosures are authorized under 6103(k)(6).

(b.) Clarify that IRS officers make the determination of the necessity "based on the facts and circumstances" at the time of the disclosure.

(c) That section 6103(k)(6) does not affect an IRS police officer's decision on his conduct when undertaking an investigation.

(d) Clarify that return information of any taxpayer (including taxpayer's name) may be disclosed when necessary to obtain information.

(e) Clarify that section 6103(k)(6) permits IRS officers to identify themselves, their organization affiliation and the nature of their investigation when

making oral, written, or electronic contacts with third a party.

(f) It is clarified that IRS police officers can introduce themselves to third parties, state that they are from the "Criminal Investigation Division" in in-person interviews and thereby disclose that the taxpayer is under a criminal investigation.

(g) Clarify that Section 6103(k)(6) does not require an IRS officer to contact the taxpayer for information before contacting third party witnesses.

(h) The new regulations clarify the old regulations by making a single objective standard for all disclosures under 6103(k)(6) and they do it by the definition of the terms "disclosure of return information to the extent necessary" and "information not otherwise reasonably available."

(i) Definition of "disclosure of return information to the extent necessary" means that the IRS officer, based on the facts known at the time of the disclosure, reasonably believes it is necessary to obtain information sought.

(j) The term "necessary" does not mean essential or indispensable but rather appropriate and helpful in obtaining the information sought.

(k) Definition of "information not otherwise reasonably available" is information the IRS officer believes cannot be obtained without the disclosure.

(l) Corroboration of information provided by a taxpayer is, by definition, information "not otherwise reasonably available from the taxpayer."

(m) The regulations do not affect the authority of the IRS officers on their decision of how to conduct their investigation. (**Note**: This eliminates any conditions precedent to authority to disclose return information.)

(n) The temporary regulations clarify that an IRS police officer may identify themselves, show their badge, say they are from the CID and that they are undertaking a criminal investigation when making oral, written or electronic contacts with third party.

(o) Regulations do not require IRS officers to contact the taxpayer for information before contacting

third parties.

(p) The IRS officers have wide latitude to determine whether the taxpayer is a reasonable source of information.

(q) The regulations expand on the list of official duties relating to tax administration for which disclosures pursuant to 6103(k)(6) is authorized. The new regulations add "or other related statutes." (The objective here seems to be to open things up for the "Patriot Act."

Appendix J

Excerpts of Defendant's Promulgation of the Amended Treasury Regulations

TEMPORARY REGULATIONS OF JULY 10, 2003

TEMPORARY REGULATIONS:

26 CFR Part 301. Disclosure of Return Information By Certain Officers For Investigative Purposes.

ACTION: Temporary Regulations and removal of final regulations.

SUMMARY: This document contains temporary regulations relating to the disclosure of return information pursuant to Section 6103(k)(6) of the Internal Revenue Code. The temporary regulations describe the circumstances under which officers . . . of the IRS . . . and the Treasury Inspector General For Tax Administration . . . may disclose return information to the extent necessary to obtain information relating to such official duties . . . . The temporary regulations amend the existing regulations to clarify and elaborate on the facts and circumstances in which disclosures pursuant to Section 6103(k)(6) is authorized. The temporary regulations clarify that IRS

and TIGTA officers . . . make the determination based on the facts and circumstances, at the time of the disclosure, whether a disclosure is necessary to obtain the information sought and that Section 6103(k)(6) does not affect the authority or decision of IRS and TIGTA . . . officers . . . to initiate, or conduct, an investigation. The temporary regulations clarify that the return information of any taxpayer, not only the taxpayer under investigation, may be disclosed when necessary to obtain the information sought in an investigation. The temporary regulations clarify that Section 6103(k)(6) permits IRS and TIGTA . . . officers . . . to identify themselves, their organization affiliation with the IRS **(*e.g.* Criminal Investigation)** or TIGTA **(*e.g.* Office of Investigations)** . . . and the nature of their investigation when making oral, written, or electronic contacts with third party witnesses. The text of the temporary regulations also serves as the text for the proposed regulations set forth in the notice of proposed rule making on this subject in the Proposed Rules section in this issue of the *Federal Register*.

DATES: Effective Date: These Temporary regulations are effective July 10, 2003.

SUPPLEMENTARY INFORMATION:

Background

Under Section 6103(a) returns and return information are confidential unless the Code authorizes disclosure Section 6103(k)(6) authorizes an internal revenue officer and officer of TIGTA . . . in connection with official duties . . . to disclosure return information to a person other than the taxpayer to whom such return information relates . . . to the extent that such disclosure is necessary to obtain information not otherwise reasonably available . . . . Disclosure is subject to situations and conditions prescribed by regulation.

The temporary regulations amend the existing regulations to reflect a recent legislative amendment to section 6103(k)(6). Section 1 of that act . . . amended Section 6103(k)(6) to clarify that officers or employees of TIGTA are among those persons authorized to make disclosures under Section 6103(k)(6).

The Temporary regulations also clarify the standard used in determining whether disclosures are authorized under Section 6103(k)(6). Recent litigation indicates that there is some confusion as to the authority of an IRS (and now TIGTA) officers . . . to make disclosures in certain situations under Section

6103(k)(6). The temporary regulations seek to address these issues. In particular, the temporary regulations address the issues surrounding the disclosures that occur when IRS or TIGTA officers introduce themselves to third party witnesses or communicate in writing using, *e.g.* official letterhead that reveals affiliation with IRS or TIGTA. The temporary regulations also clarify that Section 6103(k)(6) does not limit IRS or TIGTA officers with respect to the initiation or conduct of an investigation. Finally, the temporary regulations clarify that Section 6103(k)(6) does not require IRS or TIGTA officers to contact a taxpayer for information before contacting third party witnesses.

EXPLANATION OF PROVISIONS

The temporary regulations amend the existing regulations to clarify that there is a, single, objective standard for all disclosures under section 6103(k)(6). This standard is embodied in the definitions of the terms "disclosure of return information to the extent necessary" and "information not otherwise reasonably available."

The definition of "disclosure of return

information to the extent necessary" is a disclosure of return information that an IRS or TIGTA officer, based on the facts and circumstances known to the officer at the time of disclosure, reasonably believes is necessary to obtain information to perform properly the official duties described by the temporary regulations .... The term "necessary" in this context does not mean essential or indispensable, but rather appropriate and helpful in obtaining the information sought.

The definition of "information not otherwise reasonably available" is information that an IRS or TIGTA officer reasonably believes, under the facts and circumstances known to the officer at the time of the disclosure, cannot be obtained in a sufficiently accurate or probative form, or in a timely manner, and without impairing the proper performance of the official duties, without making the disclosure.

Corroboration of information provided by, or concerning, a taxpayer is, by definition, "information not otherwise reasonably available from the taxpayer." In criminal cases, corroboration of information provided by the taxpayer is essential.

The temporary regulations clarify that section 6103(k)(6) does not alter or affect the authority of IRS or TIGTA officers to decide whether or how to conduct

an investigation. For example, in an action for wrongful disclosure under Section 7431, the inquiry is whether the particular disclosure at issue was consistent with section 6103(k)(6), not the necessity of conducting an investigation or the appropriateness of the means or methods chosen to conduct the investigation .... The standard is whether disclosure is necessary to obtain the information sought, not whether the information sought is necessary for the investigation.

The temporary regulations also address certain issues that have arisen in criminal investigations . . . . Criminal investigations typically involve obtaining evidence and verifying taxpayer – supplied information through contacts with third party witnesses. A disclosure that a taxpayer is under criminal investigation may occur by various means including, but not limited to, direct oral, written or electronic disclosure, or indirect disclosure by the introduction of the special agent through the presentation of CID or OI badge, credentials, or business card, or through the use of information document requests, summonses, or correspondence, about an identified taxpayer, on CID or OI letterhead or that bears a CID or OI return address or signature block. In litigation, taxpayers

have asserted that CI special agents, by various means, wrongfully disclosed the criminal nature of the investigation of the taxpayer in the course of conducting third party witness, interviews or inquiries . . . . See *e.g.*, *Comyns v. U.S.*, 155 F.Supp. 2d 1344 (S.D. Fla. 2001), aff'd, 287 F.3d 1034 (11th Cir. 2002); *Payne v. The United States,* 91 F. Supp. 2d, 1014 (SD Tex. 1999), rev'd, 289 F.3d 377 (5th Cir. 2002); *Gandy v. U.S.* 99-1 U.S. Tax, CAS. (CCH) Para. 50, 237 (E.D. Tex. 1999), aff'd, 234 F.3d 281 (5th Cir. 2000); *Rhodes v. U.S.* 903 F. Supp. 819 Pa. 1995); *Diamond v. U.S.*, 944 F.2d 431, (8th. Cir. 1991).

When CI special agents disclose to third party witnesses that a taxpayer is under criminal investigation, there is a risk that the disclosure may adversely affect the taxpayers reputation, particularly if the third party witnesses have no prior independent knowledge of the investigation. The government and third party witnesses have equally important interests at stake: The CI special agents' authority to accurately identify themselves so as not to mislead third party witnesses, and third party witnesses' interest in knowing that the inquiry involves a criminal investigation to fairly assess the situation and protect their own interests. . . . This issue has concerned the

Department of Treasury and the Staff of the Joint Committee on Taxation, both of which have recommended legislation to clarify that CI special agents may identify themselves as CI special agents when conducting third party witnesses in the course of a criminal investigation. . . . The temporary regulations clarify that section 6103(k)(6) permits, but does not require, IRS or TIGTA officers, including CI and OI special agents to identify themselves, their organizational affiliation with the IRS or TIGTA, and the nature of the investigation, when making oral, written, or electronic contacts with third party witnesses.

Moreover, the temporary regulations do not require IRS or TIGTA officers to contact the taxpayer for information before contacting a third party witness. The temporary regulations clarify that, if an IRS or TIGTA officer reasonably believes, under the facts and circumstances, at the time of the disclosure, that information cannot be obtained from a taxpayer in a sufficiently accurate or probative form, or in a timely manner, without impairing the proper performance of official duties, then the officer may disclose taxpayer identity or other return information in seeking information from a third party. For example, a

taxpayer may be a reasonable source of routine business records, but not of records detailing alleged illegal transactions or sources of income. The facts and circumstances will help determine the necessity of the disclosures, but the IRS and TIGTA officers have wide latitude to determine whether the taxpayer is a reasonable source of information. The temporary regulations clarify that disclosures are authorized to verify independently, or to corroborate, from third party sources, information obtained from or concerning the taxpayer.

The Temporary Regulations expand upon the list of official duties relating to tax administration for which disclosure, pursuant to Section 6103(k)(6), is authorized. . . .

SPECIAL ANALYSES.

It has been determined that this Treasury decision IS NOT A SIGNIFICANT REGULATORY ACTION as defined in Executive Order 12866. THEREFORE, A REGULATORY ASSESSMENT IS NOT REQUIRED. It has also been determined that 5 U.S.C. 553(b), the Administrative Procedure Act, does not apply to these regulations. . . . Pursuant to section

7805(f), these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

AMENDMENTS TO THE REGULATIONS

Section 301.6103(k)(6)-1

[REMOVED]

SECTION 301.6103(k)(6)-1T

DISCLOSURE OF RETURN INFORMATION BY CERTAIN OFFICERS FOR INVESTIGATIVE PURPOSES.

Section 301.6103(k)(6)-1T(a)(1) . . . . An IRS or TIGTA officer, in connection with official duties . . . may disclosure return information of any taxpayer, to the extent necessary to obtain information relating to such duties . . . including . . .

(iv) Establishing or verifying misconduct (or possible misconduct) or other activity proscribed by the internal revenue laws OR RELATED STATUTES;

After removing regulation 301.6103(k)(6)-1(a) and (b), the new regulations state provisions pursuant to the promulgation set out above.

APPENDIX K

1. TREASURY REGULATION 301.6103(k)(6)-1

a. Disclosure of Taxpayer Identity Information And Fact of Investigation In Connection With Official Duties . . . .

> In connection with the performance of official duties ... an officer of the Internal Revenue Service is authorized to disclose taxpayer identity information . . . .
>
> Disclosure of taxpayer identity information to a person other than the taxpayer to whom such taxpayer's identity information relates . . . should be made, however, only if the necessary information cannot, under the facts and circumstances of the particular case, otherwise reasonably be obtained . . . without making such disclosure.

NOTE: 1(a) represents "Level One" which is the

first and most critical condition precedent to an IRS police officer's authority to disclose the taxpayer's name to third parties. This part of the regulation (Level One) creates a requirement for the IRS police officer to make a good faith evaluation and determination of whether the information that is sought can be obtained from the taxpayer without making the third party contact.

b. Disclosure of Return Information In Connection With Official Duties . . . .

> In connection with the performance of official duties ... an officer is authorized to disclose return information . . . .
> Disclosure of return information to a person other than the taxpayer to whom such return information relates ... should be made, however, only if such necessary information cannot, under the facts and circumstances of the particular case, otherwise reasonably be obtained . . . without making such disclosure.

NOTE: 1(b) represents level two of the regulation. It applies to disclosure of "all return

information" to a third party after the IRS police officer has satisfied the conditions precedent to disclose the taxpayer's name to third parties, as required by level one.

APPENDIX L

ORAL ARGUMENT JUNE 8, 2004

(Pages 10 – 11)

Judge Stewart:

> What I want to know is, on remand in the district court findings, are that what the agent did was a bad thing. A negligent disclosure. It nonetheless found the negligent disclosures were done in good faith. Because of that it washed clean, at that time, the negligent disclosures, to the point, that the end relief you were previously given, wiped away.

Mr. Payne:

> I understand what you are saying your honor. Let me approach it more directly.
>
> I told you that *Gandy,* how *Gandy* confused the district court, and the district court erroneously concluded, that, as a matter of law, if you show

your badge you are within the "good faith" exception. That is not the case. I will tell you the scheme of 6103. It is a two-level evaluation that the agent must make.

Level one is the first regulation passed by the Internal Revenue Service. It's Regulation 301.6103(k)(6)-1(a). It says there is a threshold, before you can divulge the name of a taxpayer under investigation, you have to make an evaluation of the necessity to do so, you have to conclude, the agent does, that you cannot get the information you need without disclosing the name of the taxpayer. Now, that's level one.

Special Agent admitted he didn't do that. The trial court found he didn't do that. This Court on the first round affirmed he didn't do that. If he didn't make the evaluation at the first level to get to the second level, where you go to third parties, if he didn't make the evaluation on the first level, he violated the regulations.

(Page 12)

In the first appeal of this case, by this Court's first opinion, the Court says that there is a level one evaluation. I have it right here. The Court on the first appeal says that such a determination of the level one, they are talking about getting information from the taxpayer, "must be made in light of the facts and circumstances of the case; that the taxpayer's cooperation forms a part of the inquiry."

So, in the first appeal of this case, the Court says that Special Agent Batista had to make the level one evaluation.

(Page 13)

We have the first opinion of the trial court saying the disclosure has to be evaluated at the first level, and the trial court's holding he did not; we have Batista's admission he did not; we

have the whole package here. As a matter of law, "good faith" is not there. Not within the "good faith exception." The regulation said he had to undertake it. He didn't. The trial court found he didn't, this Court affirmed it. "Good faith" is out of the window.

(Page 14)

Judge DeMoss:

Did the trial court find that again, on remand?

Mr. Payne:

Yes.

Judge DeMoss:

That Batista did not take the steps required in the first level?

Mr. Payne:

Yes.

Judge DeMoss:

He found it on the first go round, and found it again when you came back on remand?

Mr. Payne:

Yes.

There is no "good faith" exception applicable here, because Special Agent Batista did not fulfill the requirement of level one under (l)(a) of the first regulation. Without that, you can't go down and get into level two without authority and create "good faith" at the second level.

* * *

(Page 15)

Mr. Rosenstein:

Regarding the challenges Mr. Payne faces in this appeal is that the standard of "good faith" is an objective standard.

What is relevant to the legal issue before the Court, we believe, is a more narrow one. That

is, whether the disclosure of the issues were made objectively in good faith. The standard we use with "good faith" is whether a reasonable agent would believe that is an appropriate investigative step to take under the circumstances.

We submit that the issue has to be objective. The Court made this clear in *Huckaby*.

(Pages 19 and 20)

Judge Stewart:

The contention I have is, nonetheless, you say this is an objective standard. I don't want to quarrel with it. It seems that standard is nonetheless somehow shaped by compliance. What is the regulation? And, if the regulation requires level one, any reasonable officer, not just Batista, comply with, definitionally, not just him, but any reasonable officer would Then help me understand how we just sort of moved past that as not in play under the facts of this case.

Mr. Rosenstein:

> We don't agree that the Special Agent didn't comply with that standard. I don't think that is an accurate characterization of the district court's finding. They found Mr. Payne should get more of an opportunity to comply, as you point out, which, I take exception. She didn't find that he failed to consider it. She found that he considered it erroneously.

* * *

Judge DeMoss:

> When the agent arrives at that conclusion, does he record, in anyway, in his reports to his supervisors that he has reached the point where he needs to contact third parties? Is that a matter that he reports to his supervisors as part of the process of saying: I am getting ready to go out and contact all the customers of this taxpayer . . . ? Does he record that in anyway?

Mr. Rosenstein:

The record does not contain a specific factual claim: **"At this moment I reached a conclusion to go to third parties. We don't believe that should be required."**

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(Pages 28,29)

Judge DeMoss:

I had the sense, . . . that the purpose of the Congress was to say that in – you should not go blabber to a customer of a taxpayer that he is under criminal investigation, unless you have demonstrated a need to get some information from that person that you couldn't get from the other. Is that a fair summary of what the statutory provisions say?

Mr. Rosenstein:

I don't believe so, Your Honor. Mr. Payne is making that argument. Obviously before Congress's actions, there were no restrictions on use of tax information. I believe the information

was a free window for the government and their agents' to talk to spouses, friends, acquaintances. Under the current regime, you go home, you don't tell your spouse and friend who you are investigating. You keep it to yourself. You make the disclosures in official investigative status that are reasonably necessary.

The Court's question, I believe the purpose of 6103 was generally to contain information from the IRS, not specifically to reign in criminal investigators. It had a more general purpose."

APPENDIX M

Fifth Amendment to the United States Constitution

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.